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OVERSIGHT ON MATTERS RELATING TO THE COMMODITY FUTURES TRADING COMMISSION

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BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION

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OVERSIGHT ON MATTERS RELATING TO THE COMMODITY FUTURES TRADING COMMISSION

THURSDAY, MARCH 15, 1984

U.S. Senate,
Subcommittee on Agricultural Research
and General Legislation of the
Committee on Agriculture, Nutrition, and Forestry,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:30 p.m., in room 328-A, Russell Senate Office Building, Hon. Richard Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar and Huddleston.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator Lugar. This oversight hearing of the Committee on Agriculture, Nutrition, and Forestry is called to order.

Let me say at the outset that the Subcommittee on Agricultural Research and General Legislation will hold an oversight hearing this afternoon on the current activities of the Commodity Futures Trading Commission. As each of today's witnesses know, the substantial changes to the Commodity Exchange Act that we labored over in 1982 have had some time to work their course. After President Reagan signed this far-reaching legislation on January 11, 1983, all of us have been eager to review the results of that legislation and the growing strength of the industry.

The CFTC, the futures industry and the State enforcement officials have struggled with an overwhelming task of implementing the many changes that were put forth in the Futures Trading Act of 1982.

I believe it is important for Congress, and particularly members of the Senate Agriculture Committee to remain mindful of our ongoing responsibilities to the futures industry and to the regulators who oversee its activities. Given the need to maintain public confidence in futures markets and given this industry's dynamic annual growth, congressional oversight cannot be forgotten with each passing reauthorization.

I am hopeful today's hearing and the record we establish will help to assure continued growth with agricultural and nonagricultural futures instruments. Likewise, we must make certain the Commodity Futures Trading Commission and the National Futures Association have adequate resources to keep pace with this growth. I should mention that major issues that were addressed in the 1982 reauthorization bill included the jurisdictional accord, speculative limits, agricultural options, the registration of agents, State antifraud jurisdiction, provisions with regard to leverage; that is, the CFTC is required to issue regulations governing leverage transactions and the individual's private right of action, and, of course, a number of studies, some of them far reaching. The CFTC is required to initiate studies of insider trading, the economic impact of futures trading in conjunction with the Federal Reserve Board and the SEC and a study on large hedger's impact on the market.

There have also been issues that have arisen since reauthorization. This is not a comprehensive catalog of those, but we have noted the Chicago Board of Trade enforcement procedures have led to a number of questions and issues. The resources to monitor the new trading activity have been in question, given the dynamic growth of the industry. The budgets that are available both private and public have come into question. And, of course, most recently the SEC-CFTC agreement, an accord that has recently been tested by a dispute between the SEC and the CFTC over a Chicago Mercantile Exchange proposal to offer futures contracts on specified energy-related stocks. These issues will be in front of us today in addition to an oversight on the legislative changes that were part of the 1982 bill.

I think it is apparent that the confidence of Americans in the futures industry and the CFTC at least bear a correlation with the amount of time and effort that is taken in oversight. This public hearing will not be the only oversight activity of the subcommittee, but it certainly is an important milestone, and we appreciate the comprehensive sweep of the witnesses that have come today.

Before any of the witnesses commence, let me ask that they summarize their statements. Preferably, I would like a summary of about 5 minutes. I have a number of questions that the chairman of this committee, Senator Helms, has given to me that he would like to have submitted to the witnesses and their answers for the record. I have a number of questions and other Senators may be coming and going as the course of debate on the floor proceeds this afternoon. All in all, I am prepared to spend some time this afternoon to make certain that the record is as complete as possible.

At this time, the Chair would like to call the first panel this afternoon, it will be comprised of the Honorable Susan M. Phillips, Chairman of the Commodity Futures Trading Commission, Washington, D.C. and the Honorable Kalo A. Hineman, Commissioner of the CFTC, also of Washington, D.C.

Ms. Phillips and Mr. Hineman, would you please come to the table. As a matter of procedure, please speak as directly into the microphone as you can because that will make the job for the reporter a great deal easier and all of those who have joined us in the hearing will be able to hear what we have to say. Will you please proceed. It is good to have you with us.

STATEMENT OF HON. SUSAN M. PHILLIPS, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Ms. Phillips. Thank you very much.

I appreciate the opportunity to appear before this subcommittee on behalf of the Commodity Futures Trading Commission, and I am particularly pleased that Commissioner Hineman was able to come with me today.

In addition to the oral testimony for today's hearing, I ask the committee's permission to submit a more detailed supplemental statement for the record.

Senator LUGAR. The statement will be published in the record.[1]

Ms. PHILLIPS. Thank you.

At this time, I would really like to focus on some of the Commission's major initiatives since CFTC was reauthorized a little over a year ago, and I will be pleased to respond to any questions the committee may have.

First of all, in the area of the jurisdictional accord, we have actively followed the mandate of the Congress and the provisions of the jurisdictional accord between the CFTC and the Securities Exchange Commission contained in the 1982 amendments.

We have approved a variety of innovative futures and options contracts pursuant to that accord. The experience gained through the monitoring of the trading of these instruments over the next few months will lay the basis for even further development of additional risk management instruments. In addition, the lines of communication have been opened up between the two agencies to seek new ways of reducing the burden of overlapping and duplicative regulations. This is an area to which both agencies are committed.

The 1982 amendments lifted the 50-year ban on the trading of agricultural options. Accordingly, the Commission has developed an ag options pilot program, after a lengthy consultation process with the agricultural community. We are now accepting applications from the exchanges, as of yesterday, as a matter of fact.

If all goes well, these options may begin trading as early as this fall.

The 1982 amendments significantly broadened the role of the States with the open season provision, and the revision of section 6(d) to allow States to enforce the antifraud provisions of the act in State courts. In addition, the Commission can now share more information with the States to aid them in the preparation of their own enforcement cases.

The Commission has increased its efforts significantly over the past year to encourage and assist the States in taking an active role in commodities law enforcement. We have approached this undertaking on several fronts: Information sharing, training seminars, both on the national and regional level, cooperative State/CFTC enforcement action, and CFTC staff support for the drafting of model State legislation for off exchange commodity-related contracts.

We believe we have made enormous strides over the past year toward developing strong and effective working relationships with the States and NASAA, which will result in increased and improved public protection.

The Commission has also committed substantial resources to four congressionally mandated studies. The so-called Fed study is focus-ing on financial futures and options, the effects on capital formation, the underlying markets and their industries and the conduct of monetary policy. The three agencies, CFTC, SEC, and the Federal Reserve, intend to submit a single document to Congress at the close of fiscal year 1984.

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[1] See p. 52 for the prepared statement of Ms. Phillips.

The Commission is also conducting an examination of the implications of trading in the futures markets by persons possessing material nonpublic information. We are seeking to determine the kinds of information available in the futures markets that can be considered nonpublic and material, and who reasonably could be expected to possess such information.

A third study is expected to determine the adequacy of Commission authority to prevent unwarranted price pressures as a result of the trading activities of the largest hedgers in the livestock market. Our report to Congress is in two parts, the first of which is contained in the CFTC's 1983 Annual Report and the final part will be in the 1984 Annual Report.

Finally, the Commission will report to Congress by January 1, 1986 on the regulatory experience of the National Futures Association, the fourth study. Thus far, the Commission is generally pleased with the progress of NFA in implementing its self-regulatory program and is working cooperatively with the NFA to develop its auditing, compliance and registration programs.

Over the past year, the Commission has implemented a number of cost-based service fees in an effort to recoup the expenses of some Commission activities. These new fees are anticipated to raise $2 to $3 million in fiscal year 1984.

On January 16, 1984, the Commission adopted final rules for the regulation of certain leverage transactions by continuing the moratoria on new products and the entry of new companies into the leverage industry. The staff has been directed to report back to the Commission in approximately 6 months on the effectiveness of the rules, the resource implications for the CFTC of lifting the moratoria, and the feasibility and effects of delegating to a self-regulatory organization, such as the NFA, any of the responsibility for regulating leverage.

In addition to the unique nature of the leverage business, the lack of a self-regulatory organization interposed between the CFTC and the firms requires us to undertake a direct role in "hands-on" regulations. We plan to keep the committee apprised of the resource implications of this new program.

The many other facets of the 1982 reauthorization program that I have not mentioned here, such as streamling rules, setting up several new registration categories, and implementing speculative limits. These are addressed in the written statement.

My Commission colleagues and I believe that the staff of the CFTC has done nothing short of a remarkable job in implementing the changes required by the 1982 amendments. It has, indeed, been a busy year for the CFTC.

Thank you.

Commissioner Hineman and I will be happy to answer any questions the committee may have.

Senator LUGAR. Mr. Hineman, do you have an initial statement that you would like to make?

STATEMENT OF HON. KALO A. HINEMAN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. HINEMAN. I might just sort of bring us up to date on some of the things that we have done as far as ag options are concerned. I think the committee is aware that we had an initial comment period and then we had a series of informational meetings around the country. At that point then we decided we needed an advisory committee, which was appointed, and was very well represented from the standpoint of both agriculture and agribusiness, grain companies, the futures industry, and also the bankers. I was very glad to see them involved in this because they are a very necessary part. But the committee was of significant importance to the Commission in coming up with this rules package and making sure that everybody was represented. And, as a result of that, the proposed rules package then was published for comment in October. The comment period was over with in December and the final rules package was adopted by the Commission in January.

As the chairman said, yesterday then was the final day of the congressional layover period. We are now ready to start taking contract submissions from the exchanges. The exchanges, as you know, will write the contracts. So we are all eagerly awaiting what contracts we are going to see and, as yet, we do not have the official word, but I think everybody has probably read the same newsprints, the speculation as to what those contracts might be. The recommendation of two contracts per exchange was a decision that was made after extensive deliberations by the advisory committee. And in the advisory committee, we did not labor long and agonize over trying to reach consensus. We decided that was not the role for the committee, but, rather, to get all of the arguments out on the table. If they arrived at consensus, let us know. If they did not arrive at consensus, at least get all of the arguments out so we could look at them.

This was one issue where there was not a consensus, but all of the arguments were out there and some people argued against any restrictions and others said, "Yes, but it's a pilot program." So the limit of two per exchange was ultimately recommended by the CFTC staff.

Other than that, I would just like to talk a little bit about some of the things, since we have been in this process for about a year now, some of the things that I think we might logically expect ag options to do and some that I think we should not expect them to do. They are another risk management tool. They can work compatibly with other risk management tools or they can work by themselves. They do have different characteristics than the other risk management tools that we have available now. Very significant among those differences is they produce price protection, but it is an insurance type of price protection, or can be. In other words, protection against a drop in prices without cutting off the opportunity to benefit from a price increase. The cost of the option, the premium, would have to be subtracted then from any potential profit.

They can offer predictable hedge costs. In other words, they know up front what the premium is, so they know exactly what that protection is going to cost. There are no margin calls for the option buyer, which is different than futures.

Options can give price protection prior to harvest time without magnifying production risks. I think this is a role that people might look on with favor for options because they do not want two kinds of risks. At least this way they know what the cost of that protection is. The other risk that they have is they do not know if they are going to raise that crop or not, so they do not like to have two risks at once.

As you can see, options are different, have different characteristics, and so can do different things.

One other thing I think I should mention is some of the things that I do not think we should expect ag options to do. I do not think they can increase or decrease commodity prices. I do not think that ag options can affect the commodity supply or the commodity demand. I think ag options could not have any significant effect on nonparticipants in the options market. An option is an individual, marketing tool and if I, as an individual, buy an option then that is just for me. It only affects me. Options could not perform some of the functions of farm price support programs, and I might just very quickly run over those.

Federally established loan rates generally have acted as a price floor during the crop year. Further, price support levels have not declined from year to year in the past, thus providing basic downside price protection to the agricultural section. Options will not offer this kind of downside price protection to the agricultural market. They do offer protection to the individual. But that protection the individual gets is at a level that he can secure in the marketplace. It has to be at a level the marketplace offers to him.

Trading in options will not withhold grain from the market. However, if a producer places his crop in Commodity Credit Corporation stocks in exchange for the loan, grain is withheld from the marketplace. Price support programs have often had mandatory acreage reduction features as a requirement of producer compliance and, therefore, have reduced the supply of the commodity produced. Options add no such supply control function as these two measures to the marketplace.

I might talk just quite briefly about some of the meetings we have had around the country recently. The interest level is really going up. I was at a meeting out in Topeka, Kans., the other day, a marketing meeting of over 500 people. Frank Naylor from USDA was there also talking about Federal crop insurance. But at every meeting that I have gone to in the last 6 months, the numbers just keep going up. So it is a program that is of much interest out there and, yet, the real education work is yet to be done. And, as one of my economist friends out in Kansas told me the other day, he said, "You know, we have to start with the basics. We have to teach futures before we can teach options, because if we don't teach the farmers some kind of market discipline along with this, then we really haven't done them any favor." And I think that is right. There is a lot of work to be done. The teachable moment is here. It is of interest.

Senator LUGAR. Thank you very much, Commissioner.

I would like to review the basic issues in the 1982 bill, and you both have touched upon these in some way. Just for sake of a comprehensive look: First of all, the 1982 legislation dealt with the jurisdictional accord, an agreement that had been reached between the then CFTC Chairman, Phil Johnson and the SEC Chairman, John Shad over the trading of stock index future contracts, and I know that you have been busy in the further implementation of that agreement.

In a public meeting recently, charges were made that the SEC might very well gain dominance over the CFTC due to recent activities. I want to offer an opportunity for the two of you to comment on the integrity of the two institutions, their likely relationship and your own general feeling as to the future of the CFTC, given some confusion which seems to be abroad as to whether there are changes or shifts in jurisdiction, or, in the worst case scenario, the CFTC might disappear someday altogether. Would you have any thoughts about that subject this afternoon?

Ms. PHILLIPS. Why don't I start out, and, Commissioner Hineman, if you want to join in, feel free.

First of all, I think that one of the things that was very constructive about the 1982 amendments was to open up the lines of communication between the two agencies and to help define what the jurisdiction was of the respective two agencies. There were developing a number of new instruments that exchanges wanted and were seeking to be considered both under SEC jurisdiction and under CFTC jurisdiction. And I think that the jurisdictional accord was very helpful in getting some of those instruments, as I say, out of the courtroom and into the trading pit, so that they could start trading. I think, quite to the contrary, as was suggested, that the 1982 amendments actually gave the two agencies an opportunity to work together, to open up the lines of communication and to secure ways that both regulatory agencies could try to learn to accommodate changes in their respective market structures. So I do not feel, by any stretch of the imagination, that there is any chance that the CFTC is going to be swallowed up by the SEC, or vice versa, for that matter. I think that trading activity in the futures area has certainly expanded into many, many new areas. So I do think there is a lot of experimentation in development that does need to work itself out in the marketplace now. And I think there are a lot of new instruments that are trading, or potentially may start trading, that may or may not be in the long run viable products. But both agencies have tried, while preserving the safety, the soundness, and the integrity of the markets, to allow some of these new products to develop and tried to be responsive and flexible within the confines of our statute, but looking to the development of new risk management tools.

I probably gave you more than you wanted to hear.

Senator LUGAR. No, I think that was very helpful, and I would respond, for the record, that I think it is important to do this from time to time. The farmers in this country and the businesses involved in agriculture are very supportive of the CFTC and the idea that it ought to evolve as a strong organization with strong support.

This committee, the Committee on Agriculture in the Senate, is the committee that has jurisdiction with regard to CFTC, and our chairman, Senator Helms, feels very strongly that the CFTC must be supported. This is our purpose, of course, for calling this oversight hearing. And there is no challenge of jurisdiction within the Senate. This committee does have jurisdiction and will continue to have jurisdiction.

I think it is important probably at these benchmark meetings to establish where we all are, so that not only will those who are involved in the Senate, as well as in the regulatory agencies, know where jurisdiction lies, and that the public might not have any confusion either.

Let me ask, with regard to the very technical area of limits that are authorized by the CFTC, or, rather, CFTC was authorized to establish. These were provisions to have different maximum position limits, depending upon the number of trading days remaining in a contract. The reauthorization bill also prohibited exchanges from fixing position limits which are higher than the maximum limits fixed by the Commission. These actions attempted to lessen the possibility of price fixing, particularly during the closing days of the trading or contract, when most commercial hedgers are liquidating their position. What has been your experience with those new provisions?

Ms. PHILLIPS. We have been in the process of working with the exchanges to put speculative limits into place in a comprehensive fashion. Even before the 1982 amendments, there were some position limits in some commodities. So it has been a continuing process and, certainly, as we have designated new contracts, we have put into place speculative limits. We have a few outstanding issues with some exchanges, but I understand we are very close to working out some of those issues and we fully expect that all of the limits will be in place very shortly.

There are limits for speculators, and these are position limits, so there are not volume limits. I think that is something that is not as widely understood. Certainly, having position limits, however, probably is going to affect somebody's trading volume. So it does have some carryover effects. But I think that it has been helpful in looking to preventing, and working toward preventing, potential market congestion.

I would say that when you are talking about commercial users, which is the last part of your question, I believe, we do not have limits on hedgers. So if the market participants are bona fide hedgers, and the exchanges are then really the ones to look into whether or not they are hedging or whether they are speculating. If they are commercial participants in the market, then they may be bona fide hedgers. There would not be limits on them. The limits are to be applied to speculators.

Senator LUGAR. Thank you.

Commissioner Hineman has already discussed some of the provisions the Commission has made in preparation for the ag options feature. I would like to ask Commissioner Hineman, or either one of you, for that matter, if you have additional thoughts.

Do you have any indication as to which exchanges will be involved at this point?

Mr. HINEMAN. The most common thing I hear is that the Chicago Mercantile Exchange will probably be asking for contracts in live cattle and live hogs, and these are still prospective. We have not seen the applications yet. And that the Chicago Board of Trade will be submitting contracts for soybeans and for their second contract. It is unsure yet whether it would be corn or wheat. The Kansas City Board of Trade intends to submit a wheat contract. The Minneapolis Grain Exchange intends to submit a wheat contract.

At one time I had heard that the Mid-America Commodities Exchange was going to submit a wheat contract, but I think they are a little unsure which one they are going to do.

The cotton exchange is going to submit a cotton contract. I believe that is the total of the list as of now.

Senator LUGAR. From the public hearings that you and perhaps other Commissioners have conducted, as well as correspondence or other indicators, how many farmers do you anticipate will be involved in ag options trading initially?

Mr. HINEMAN. I think, realistically, we have to expect that by and large the larger and more established farmers will be using it, probably the same people who use futures, with maybe some expansion. But at first I think we would be looking to that body. And for the vast numbers of farmers I think they are going to want to see some performance. They are going to want to find out about this before they jump in. I think that once the educational efforts begin to take hold, maybe they will understand them a little better than futures, when they get to understanding the price insurance concept, with which they are familiar, and seeing a premium as a cost of doing business. But to actually get a big volume of participation from farmers at the outset, I am not one of those who say that I think that is going to come real fast.

Senator LUGAR. As you know, a good number of individuals as well as groups in our society are giving a great deal of thought to the farm bill of 1985. We will necessarily have another quadrennial period and 4 years of legislation beyond that, but there is some thought that may be a comprehensive debate.

To what extent could ag options replace a part of the farm support price structure that is in current legislation?

Mr. HINEMAN. With that in mind, it is one of the reasons we sat down and tried to determine what we thought the differences were in characteristics between options and the farm price-support programs. We have also done this same thing for the difference in characteristics between futures and options and also forward contracts, which are a very important tool for more farmers, probably, than any other of the tools, other than price supports—forward contracts with their local elevators.

I think, and bearing those characteristics in mind, and those limitations in mind, I think that options can take their place alongside futures and forward contracts as risk management tools and help to take up the slack that might be left there by a lessening of impact of other risk management tools or some decrease in the cushion of risk that I think my generation of farmers had. In fact, one of the main cushions was the increase in land values and ability to borrow against it. And that is not the same now. So that by itself highlights the need for some additional risk management tools. If the price-support program were to be dramatically changed in such a way that there would be additional need in the way of a risk cushion, then to that extent I think ag options could be expected to take their rightful place alongside the other risk management tools as one that might be attractive.

Personally, if I were back on my farm, I think I would not use one to the exclusion of the others because they do have different characteristics, and I do not think I would put all of my eggs in one basket.

Senator LUGAR. What role would NFA play in the regulation of ag options?

Mr. HINEMAN. The same as they do now. They will be registering the participants, introducing brokers and others, and all of the regulatory functions they do now, plus the audits they do now, the audits of the FCM's and so forth. And, you know, that is invaluable to us and I am an enthusiast of the NFA and I want to see them get up and get to doing all these things as fast as possible. I am pleased with what is happening.

Senator LUGAR. Let me ask regarding the provisions in the 1982 act on registration of agents and, for the benefit of all of us, those provisions require employees of introducing brokers, or Futures Commission Merchants to register with the CFTC. CFTC has set minimum financial requirements for these persons in order to prevent uncontrolled solicitation by unscrupulous brokers.

What has been your experience thus far with that provision?

Ms. PHILLIPS. Well, we have developed a comprehensive regulatory registration program for introducing brokers and employees, or essentially associated persons, of introducing brokers. Those regulations were first put out for comment last spring and we received—I received a lot of mail on that subject. And we spent a good bit of the next couple of months reviewing those comments and our Director of Trading in Markets went out into the field and met with some of these people who would be affected by these regulations.

I think one of the things that we found was that these were people who had never registered with a Federal agency, and probably did not even know they were going to be registered. And they do business in many different ways. So we did a major revision of the regulations and subsequently put them out later in the summer and provided several ways in which they could meet the requirements. They could either be sponsored by an FCM or if they were introducing as an independent introducing broker, they would then have to meet certain capital requirements. And I am pleased to report that the NFA, from the inception, has administered the introducing broker registration program. And that has been a great help to the Commission. I think that they have found that in registering these people when they apply and they fill in those forms, a lot of the forms have been deficient. So it has been a slower process than I think anybody had originally envisioned. But we think that it is proceeding quite satisfactorily and that NFA has worked out the kinks of that program, and I think it is well set up.

Senator LUGAR. As you recall, both during the hearing and the markup, especially in the conference on the 1982 legislation, the whole issue of States' antifraud jurisdiction played a large role in our thinking. The reauthorization bill increased State enforcement authority by allowing States to proceed against registrants, except for brokers, in State courts for violation of any State or Federal statute. That is so-called open season.

Prior to this time, States could only enforce State laws in State court. In addition, the new law mandated cooperative enforcement and shared information between the States and the CFTC.

Can you trace the evolution of relationship since that, since the new law came into effect?

Ms. PHILLIPS. Yes; I will certainly try.

Shortly after the act was passed, we did make available to the States an analysis of the 1982 legislation so that they could take full advantage of implementing, or utilizing their new powers.

We have found in working with the States on a day-by-day basis that it has been necessary, and we have wanted, to reach out to the States and work particularly with the organized State association, NASAA. And we have, in trying to reach out to the States, have held several seminars that were put on by our Division of Enforcement, in cooperation with other people within the Commission. And, in fact, NFA also participated in these seminar sessions. We held a national scope here in Washington and then we took one out on the road to Los Angeles. They were 2-day seminars.

They have been very helpful. The Division of Enforcement pulled together a major compendium of materials on how basically to file these kinds of cases. And, in addition to that effort, we have set up within the Division of Enforcement a State and Federal Liaison Unit, so we have a focus by which we can work with the State authorities. And, since the passage of the act, I believe we have filed jointly with the States approximately 12 cooperative cases.

Most recently, one cooperative State/CFTC case was filed in Arizona, in which I understand the securities people out there, who were the ones administering the case or filing the case, did a good bit of the work themselves. And they had been attending our seminars.

I feel that these educational efforts are something that we need to support. The Commission thinks it important to continue to support these activities and devote resources. It is really a partnership with the States. They are what I like to think of as the cops out there on the beat. And if we can support those efforts and augment them through our expertise, I think that will be an effective way to approach commodity antifraud efforts.

Senator LUGAR. What has been the experience under the new act with regard to the requirement CFTC issue regulations governing leverage transactions?

Ms. PHILLIPS. Yes, last summer; as a matter of fact, we did put out for comment comprehensive leverage regulations. And he did discover, as part of that process, that there were quite a number of leverage firms already in existence. I think we had all been thinking that there were really only a few leverage firms out there and that the regulation of the leverage industry was not going to be a major resource concern for the Commission.

We did find, as a result of putting out those regulations for comment, that there were many more firms than we had thought. And because of that and because of our uncertainty with respect to exactly what the scope of our regulatory authority would be, we thought it would be appropriate to keep the moratoria in effect and implement the proposed regulations, revised proposed regulations, might I add, on an interim final basis, but keeping the moratoria in place with respect to firms and products. So that is where we are now. And those regulations have been promulgated in final form and we are in the process of working with the firms that are grandfathered in, so to speak, under the moratoria to get them registered.

So we are well on our way in the area of leverage regulations. And I might add as a followup to your previous question, once we issued final leverage regulations that contained a definition, we began working with the States in order to dovetail the draft model State legislation with our existing leverage regulations. So we believe that that process is well underway, too.

Senator LUGAR. What comment can you make on the provision of the 1982 act that provided for private right of action; that is, that authorized victims of commodity frauds to recover actual damages resulting from any individual's violation of the Commodities Exchange Act?

Ms. PHILLIPS. I am not sure we, in fact, have at the Commission, a full count of the number of cases that have been filed relating to private right of action. There have been a number of suits brought, and we certainly are trying to keep up with them to the extent, in particular, that it involves novel issues for the Commodity Exchange Act. We want, certainly, to keep up with any case law that is developing in that area.

There have been a number of cases filed. We do not see that it has made a great deal of difference, for example, to our reparations program. That is still being widely used as a forum for customer disputes.

So, there have been suits filed, but I cannot say there has been an enormous onslaught.

Senator LUGAR. Chairman Phillips, you mentioned that with regard to the studies that CFTC was charged to make, as well as its cooperative endeavor with the SEC and the Federal Reserve, at least in the broader study on the economic impacts of futures trading, you thought that would be concluded by December 1984; is that correct?

Ms. PHILLIPS. Actually, it is earlier than that. Yes, it is at the end of the fiscal year, the end of September. And I understand that we are proceeding on target and they are still anticipating completion by the targeted date.

Senator LUGAR. Now, how about the study on insider trading?

Ms. PHILLIPS. Yes. That also is due within the same time frame and that, of course, is being done by CFTC. It is proceeding, I would say, on two fronts. One area is largely considered analytical, trying, first of all, to figure out what insider trading might be, or what nonpublic information might be, and who might, in fact, possess such information.

One of the things that we have discovered really was partially in connection with our large hedger study, another one of the studies in which we were doing some interviewing of some large firms. We were asking these large firms what were their policies with respect to their employees' trading futures that are related to the firm's commodity. And we determined as a result of those interviews that it would be appropriate for us to expand that line of inquiry. So we are in the process of surveying to find out the terms or what the firms' practices are. So there will be an analytical section and also some statistical analysis. And that again is being done by the CFTC and should also be submitted this fall.

Senator LUGAR. And the report on large hedgers, their impact on the market, how is that coming?

Ms. PHILLIPS. Well, we have published as an appendix to our 1983 annual report the first part of that, and we are using several methods to look at the impact of large hedger activity. It is, as you know, confined to the livestock market, although we are looking at a couple other areas as a basis of comparison. We are using our large hedger report so there will be some statistical data on that.

We are examining in depth whether there were any disruptive markets during this 2-year period, and we did review in detail the Chicago Mercantile Exchange's emergency action this past summer in pork bellies, and that is included in the 1983 report.

The third area in which we are examining large hedger activities is through indepth interviews with large hedgers, onsite interviews if you will. And at the time the 1983 annual report was done, I think we were about halfway through those interviews. So that has yet to be completely compiled.

Senator LUGAR. I thank you very much for your response to each of these items. For the record, I would simply indicate again that in 1982, as both of you are aware and your colleagues, extensive hearings were held by this subcommittee as part of the reauthorization procedures. That was true also in the House of Representatives. And we proceeded through several days of markup with highly technical provisions, and which each of the members of the subcommittee and the members of the full committee had to become knowledgeable about subjects in which some of our colleagues would prefer not to have become knowledgeable. This is a complex business, even for those who are involved in it. And members of this committee are not. But we are trying to take as careful a look as we can, both as legislators in formulating legislation, and in an oversight review so that our work might be open to your comments, the comment of the public and the press and our other colleagues.

Now, while I have the two of you here, I want to conclude this part of the hearing by reading a letter that I have received from two of my colleagues; namely, Jim Abdnor, who is chairman of the Agriculture and Transportation Subcommittee, and Chairman Roger Jepsen, of the Joint Economic Committee. And they have written me a letter that was dated March 12 that I received just today.

They said:

"Dear Dick:

"We understand that your Subcommittee on Agricultural Research and General Legislation will soon be holding an oversight hearing with respect to the Commodity Futures Trading Commission.

"As you may be aware, on January 23 in Chicago the Joint Economic Committee held a hearing on the topic, 'Farm Commodity Market Performance and Economic Forecasts.'

"Following last fall's predictions by many commodity experts of future soybean prices in the range of $12 to $15 and corn prices pushing previous record price levels, prices for both soybeans and corn have plummeted.

"Farmers wanted and deserved an explanation.

"Witnesses were called representing Chase Econometrics (a large highly respected economic forecasting firm), Iowa Soybean Association, Iowa Corn Growers, U.S. Department of Agriculture, the Commodity Futures Trading Commission (CFTC) and the Chicago Board of Trade.

"The primary objective of the hearing was to generate discussion and understanding of market forces which have resulted in disappointing and highly volatile soybean and corn prices. Witnesses were also asked to comment on reports in the press of price manipulation by a few large firms and the recent CFTC surveillance audit of the Chicago Board of Trade which was highly critical of the Board's trading rule-enforcement program.

"Some of the hearing's most significant findings were:

"(1) Both the CFTC and the Chicago Board of Trade admitted that there is opportunity for market manipulation.

"(2) Both the CFTC and the Chicago Board of Trade informed the Committee that they presently have ongoing investigations into alleged market abuse by selected firms.

"(3) The positive price effects of low 1984 ending stocks for soybeans and corn is offset by the price depressing effects of the value of the dollar, expectations of a large crop in 1984, remaining large stocks of wheat, a depressed livestock sector, the limited credit of importing countries and a good crop in the Southern hemisphere, among other factors.

"(4) Farmer witnesses effectively expressed the frustration, distrust and alienation of American farmers relative to the commodity exchanges.

"(5) The relationship between the U.S. Department of Agriculture, the Commodity Futures Trading Commission and farm commodity groups must be strengthened and formalized.

"It is the intention of the Joint Economic Committee to convene a followup hearing at which time commodity traders, including speculators, will be invited to share their views on market performance and operations and price developments.

"If we or the staff of the Joint Economic Committee can be of assistance, please do not hesitate in contacting us."

Do you have any comment about the findings of this committee, particularly with regard to the allegation or assertion that CFTC and the Chicago Board admitted that there is opportunity for market manipulation and that you have ongoing investigations into market abuse?

Ms. PHILLIPS. Yes. Let me say, first of all, we did participate in that hearing out in Chicago, and had prepared some materials which we also submitted to the Senate Agriculture, Nutrition, and Forestry Committee at the same time.

Beginning last summer, and I think you have to start back even a little further, there was a great deal of uncertainty and volatility in the market and there were certainly two areas that we could identify that created a great deal of uncertainty, the drought and the PIK program. Both of those factors created a great deal of uncertainty as to how much grain would be available, where, and at what time.

That price volatility was certainly reflected in the cash market and it was reflected in the futures markets.

We at the Commission really tightened our surveillance efforts last summer and all through the fall, and worked with the exchange involved very closely to monitor those markets. And around a couple of expiration dates, I might say that I was on the phone myself, almost on a daily basis to work out certain problems. We worked very closely with the exchange at that time.

So it was a heightened period of examination of those markets. The Commission's job is to look at the relationship of the futures prices to existing cash prices and to look from one futures price to another futures price to try to determine if there is any price distortion relative to existing cash price information.

We have not been able to identify that, and I think this is one of the things that came out in the hearing. Both USDA and Chase Econometrics testified that they believed that the prices were reflective of fundamental supply and demand pressures. And we had no reason to believe otherwise.

Some of the other areas that were alluded to, I believe, in that letter had to do with some concerns about speculative limit violations. We do have an ongoing staff inquiry into that. We, to date, have not been able to locate any individuals who were violating speculative limits.

The tougher question is whether or not there is any trading in concert. That requires some fairly sophisticated analysis, and we are continuing to study that question.

I might add that the exchange involved also is pursuing that kind of investigation. So I think we both, and I think it is partially because the markets were so volatile, have spent a lot more time this past year on the agricultural commodities than we did, certainly, in the first 2 years that I was at the Commission.

Commissioner Hineman, would you like to add anything?

Mr. HINEMAN. I would only say, in regards to the remark, that it is possible for the markets to be manipulated. I think you always have to assume that that can happen, just like you always have to assume there can be crime on the street. But, as a regulator, you do the best job you can to try to make sure that manipulation does not happen and some of the ways we do this, as the chairman just recited, involve investigations that have to happen after the fact, and some of these investigations take time, to determine whether there is or is not a pattern developed. So we would never take the attitude that something like that could not happen, but I think we have a staff that is on top of this all the way and I feel comfortable with that staff.

Ms. PHILLIPS. We are always hopeful that we are going to be able to prevent problems so that we do not have to go into after-the-fact kinds of investigations. And much of our regulatory program is structured around prevention, as are the exchanges' programs.

Senator LUGAR. I simply want to express my own personal appreciation and that of the subcommittee and the full committee to both of you, and to your associates at the Commission. You have been most forthcoming as questions have come from members of the committee, and we appreciate your taking the initiative in many instances to report on developments to make certain that we were apprised. I appreciate your coming today and offering this testimony.

You are dismissed and the hearing will be recessed for approximately 6 to 7 minutes while the Chair votes.

[A short recess was taken.]

Senator LUGAR. The hearing will come to order again. The Chair would now recognize Robert Wilmouth, president, National Futures Association, Chicago, Ill.

Mr. Wilmouth, welcome again to the committee. And we look forward to your report on the work of the National Futures Association, to which you devoted a great deal of attention prior to its foundation and, how, of course, you have played a leading roll in its success. We look forward to your comments.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILL.

Mr. WILMOUTH. Thank you very much, Senator.[1]

Let me say that I am delighted to be here before you again, this time I think under far different circumstances than my last appearance before this committee.

During the 1982 hearings on CFTC reauthorization, at that time, I think the very existence of the National Futures Association was in serious doubt. I think I can emphatically state to you today that this is not the case. NFA is alive and very well.

Perhaps to prove my point somewhat, let me give you a few statistics as they may prove helpful to you.

First, our membership. All 10 independently operating U.S. Futures Exchanges are currently NFA members, as are, using the date of February 29, and excluding multiple memberships, 338 FCM's, 434 commodity pool operators, 406 commodity trading advisors, and 54 introducing brokers.

The result of this membership is that in conjunction with both CFTC and NFA rules, all futures industry professionals are now subject to self-regulatory oversight. With regard to NFA, specifically, the many FCM's, CTA's and CPO's who were not exchange members, and some of those I believe we might say operated in the twilight zone of regulation, are now under NFA oversight, and are subject to our customer protection rules and standards.

When we first began our regulatory operations, some 17 months ago, on October 1, 1982, our staff already consisted of 60 individuals. As more of our programs have become operational, we have grown to 160 today, with compliance and related registration staff comprising just about three-quarters of that total. We have offices in Chicago and New York and, on any given day, we have an average of more than 45 people engaged in field audit and financial surveillance activities.

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[1] See p. 69 for the prepared statement of Mr. Wilmouth and pp. 76–108 for a detailed statement submitted by Mr. Wilmouth.

Compliance, first and foremost, is what NFA is all about. It encompasses a variety of activities. Financial surveillance, field examination, special investigations, all designed to prevent violation of our rules whenever possible and to initiate prompt corrective or disciplinary actions whenever necessary.

Firms and individuals subject to NFA compliance requirements must maintain complete, accurate and up to date records. They must remain properly capitalized. They must segregate and account for customer funds and adhere to ethical and honest business practices.

To enforce these rules, a total of 342 examinations were conducted by NFA auditors through February of this year. Additionally, in 40 instances, our daily financial surveillance of the nonexchange firms, handling customer funds, found possible rule infractions that led to appropriate NFA action. And, in response to indications of potential serious rule violations stemming from audits, referrals, or public complaints, NFA staff has conducted a total of 106 preliminary inquiries, which have led to 13 full-scale investigations.

Also consistent with NFA's customer protection responsibilities, our compliance personnel routinely monitor sales literature and other solicitations involving, or appearing to involve futures. Also screened are advertisements for employment in the futures industry, particularly for sales personnel.

In all instances, the objective is to assure that persons considering futures transactions receive adequate, accurate and straightforward information upon which to base their decisions.

When violations of our rules are found, we possess both the authority and, in my mind, the determination to deal swiftly and appropriately. Already our regional business conduct committees have issued 13 formal complaints, as well as a number of warning letters. And when a situation arises, where an immediate risk to customers or the industry requires an immediate remedy, NFA has the power to take appropriate member responsibility actions on a summary basis.

Let me give you an example that happened just last week. We performed a surprise audit in San Diego, Calif., on a commodity pool operator because we believed that she was reporting unusually high profits in soliciting prospective participants. The audit showed that over $1 million in a commodity pool that she operated was missing. And we took appropriate action literally within a matter of hours of finding that out, and worked cooperatively with the CFTC, who has already gone to court and taken all the necessary actions that we feel are appropriate in a circumstance such as this. So we can act and do act immediately, and have the authority to do so.

We can bar a firm from soliciting or making any additionl futures transactions, which we did in this case. Its NFA membership and right to participate in the futures market may be suspended or even terminated, and we have done that in terms of a number of cases. Totally, about 18 membership responsibility actions have been taken since our inception.

In the area of registrations, NFA is already playing a major role in the registration of introducing brokers. And, since you asked the question of Chairman Phillips just recently, let me bring you up to date on the registration activities we have performed over the past several months ago. And this information is accurate within about 24 hours, incidentally. We had received a total number of introducing broker applications as of Tuesday, March 13 equaling 993. We registered 175 of those; 166 withdrew; 50 were forwarded to the CFTC because there was some derogatory information on the application itself, or we obtained it while we were checking SEC files or FBI fingerprints; 136 of these are awaiting clearance from the SEC, the FBI or our own internal compliance department, which does a financial review of their statements; and 374 of these are deficient applications. They have already been processed by NFA, but we have had to go back to the original applicant and seek a response from him because, for example, signatures were missing from the application, there were smudged fingerprints, there was a lack of financial data we had a question on the principals of the members of the firm.

Some of these applicants, incidentally, have received the same deficiency letter as many as three times, and we constantly follow up with phone calls and additional correspondence.

When a response is received to one of our deficiency letters, then we act within 48 hours of that time.

And, finally, to add to 993, 92 of these files are currently being processed and these 92 will either be granted registration or receive a deficiency letter within 15 days. So we believe that all of these applicants have either been approved, have been notified of application deficiencies, withdrawn, referred to the Federal agency for fitness checks, or referred to the CFTC for denial. So we are 100 percent up to date in this area.

We are also fully committed, incidentally, to making a temporary licensing program viable as early as May 1 of this year. We have worked out the procedures with the CFTC and the industry and NFA staff will be supplied to the CFTC on their premises to work on the program until it is finally turned over to us sometime later this year.

Yet another important accomplishment of NFA, after about 16 or 17 months of existence, has been the development and implementation of our arbitration program. Designed to be an alternative to litigation or CFTC reparations, its purpose is to promote a fair, as well as a generally faster and less expensive means of resolving futures-related disputes between the trading public and our members.

The NFA arbitration system became operational on March 31, 1983, without any fanfare or publicity, and already we have received a total of 137 notices of intent to arbitrate and 58 formal demands for arbitration have been made. Eleven claims have been settled prior to hearing; 9 cases have been resolved through hearing and award; 18 others are ready for hearing, and we are now going public in terms of advertising the arbitration facility now that we feel comfortable in administering such a program.

We think it is a timely one. Speed is an important goal of our program but, also, convenience is an important goal. We attempt to schedule arbitration hearings as close as possible to both parties. And, to accomplish this, we already have a roster of almost 250 qualified arbitrators in 29 different States.

At the risk of overstaying my welcome, let me just make three quick additional points, if I may, with your concurrence, with respect to NFA.

First, you noted that jurisdiction is again alive and a topic of debate, and you commented upon how much attention State jurisdiction should receive. I, for one, believe that subject has received substantial attention and substantial progress has been made in the area of State jurisdiction vis-a-vis the CFTC. As a first step, we named last year one of our senior staff members as enforcement liaison to all 50 States through the North American Securities Administrators Association, with whom we have established an exceptionally fine rapport.

Through our initiatives, in cooperation with the CFTC, a number of very productive meetings have been held with State officials, represented through NASAA. Commissioner Fowler West and representatives of NASAA and the CFTC met with us in Chicago in January. We agreed to form a working group to draft some model State legislation to give the States better tools to deal with off-exchange commodity-related investments. That process is now underway, as I think Chairman Phillips commented. Meetings of the working group have already been held. An initial draft of model State legislation is being circulated and will be reviewed at a meeting in Atlanta on March 28.

The second point that I wanted to make is that, throughout our startup period, we have received the full, and, I would say, active support of the CFTC. The Commission and its staff have cooperated with us at every turn. They have encouraged us in every way. There have been no petty jealousies that you might expect when a new kid on the block comes on board for the announced purpose of taking over a little bit of someone's turf.

And I might add, as a final point, that the same must be said for the futures industry. Through direct participation on our governing board, our regional business conduct committees, our arbitration panels, our advisory committees and our task forces, literally hundreds of futures industry professionals, from the exchanges, from brokerage firms, from the Futures Industry Association, have been most helpful, and particularly from the National Association of Futures Trading Advisors, which will present testimony later today. They have all rolled up their sleeves to build a very viable and effective NFA, and I think the commitment of this industry to NFA has been extremely effective.

I must also conclude my remarks, I think, by saying that this committee was the one that first gave us the chance to take part, the industry itself to take part in the self-regulatory process. We felt we could do it. We felt we would do it, and I think that, thanks to the encouragement and wise judgments which were made by Congress in 1982 in the reauthorization, that the futures industry today is stronger and better policed than it has been before. I think our programs and our systems for customer protection are second to none. I am very proud of this. I am very proud of the industry and proud of everyone who has participated in this effort.

Thank you very much.

Senator LUGAR. Thank you, Mr. Wilmouth for your opening statement. I have a number of questions that I think will establish as complete a record as possible today.

I would ask, first of all, what is the NFA's current budget?

Mr. WILMOUTH. Our current budget for the fiscal year ending June 30, 1984 is $10.3 million.

Senator LUGAR. Will the NFA grow beyond the present size of 160 persons in its employ, which you have mentioned in your opening statement?

Mr. WILMOUTH. Let me say that we are presently putting together our budget for fiscal year 1985, beginning on July 1, and that budget will be substantially increased as will the number of people. My estimate of people probably will come as high as 250 people in order to adequately perform all of the tasks that have been assigned to us.

Senator LUGAR. Out of curiosity, where are the people located; in what community?

Mr. WILMOUTH. We are all located in Chicago, in one office, with the exception of approximately, as of now, 16 auditors who are located in New York City. Our bylaws require us to have an office in Chicago and New York. We are contemplating, purely from a cost savings and efficiency standpoint, the addition of an office someplace on the west coast.

Senator LUGAR. In what areas will the growth of both your budget and personnel most likely occur? Could you give some estimate of the projected budget for fiscal years 1985 and 1986?

Mr. WILMOUTH. There is no doubt in my mind that the additions to our budgets will occur basically in three areas that are all interrelated. By far, our No. 1 addition will be in the compliance area. That is first and foremost what NFA is all about, a compliance organization.

Registration is the second area because we have a responsibility to have on our files by the end of this calendar year approximately, I believe it is now, 105,000 names of entities or individuals that appear on the CFTC registration files in far greater detail and far more information than they have. So those two areas, compliance and registration right now comprise about 75 percent of our total personnel and will be in that same proportion in fiscal year 1985.

The only other area that I see any significant increase in people—there will be none in the support areas, or a very modest number—will be in the arbitration area.

We are currently debating how many cases we budget for fiscal year 1985. My guess would be, personally, and I have not sat down and worked this out in detail with our staff, in the neighborhood of about 300 or 400 cases.

You asked about the size of our budget. I do have a finance committee with which to review this. My estimate would be that our budget would be at least 50 percent higher in fiscal year 1985 than it was in fiscal year 1984.

I would hope, eventually, to stabilize that budget in terms of the amount of money that comes from the revenue source of FCM's assessment fee and obtain additional sources of revenue from specialized services that we would perform. But it will be substantially increased in fiscal year 1985.

Senator LUGAR. Given the size of your current audit and compliance staff, how frequently will NFA be able to audit all of the brokerage firms that are not members of exchanges? And how frequently will you be able to audit members that are commodity pool operators?

Mr. WILMOUTH. We have a schedule right now, Senator Lugar, which indicates—well, first of all, let me say that every FCM who is not a member of an exchange has been audited fully by NFA so far. We have also performed, in addition to what we call full scale audits, some limited scope audits. Our schedule calls for a full scope audit to be done a minimum of once every 2 years.

I might also add in the case of about 35 to 40 firms we are in daily phone contact with them from a financial surveillance standpoint. Anytime we suspect a problem, or we see something that might occur because of a firm's heavy concentration in one area where the markets are very volatile, we will go in and do a surprise audit. Technically, however, I think the answer to that question is once every 2 years.

With respect to commodity trading advisors who do not have any actual funds, we will do that on an as-needed basis. As of March 9, we had already performed 18 audits of commodity trading advisors.

On combination pool operators and trading advisors, we have done 73 audits so far. On firms that are commodity pool operators only, as of March 9, we have done 61 audits. Such audits are scheduled for at least once every 3 years. But, again, as we go through disclosure documents, as we go through customer sales literature, as we receive complaints from members of the public, we go in and make a surprise audit. But on a scheduled basis, we will do it probably once every 3 years.

Introducing brokers will be on a minimum schedule at least once every 2 years. The case out in California that I mentioned to you previously was a result of looking at disclosure documents and feeling that the investment results which were being promulgated by the pool operator were too high. We did a surprise audit and confirmed the problem. And I think things like that will occur all the time. So it will probably be done more than that, but on a regular schedule basis, once every 3 years for pool operators.

Senator LUGAR. Following up on the California incident, as a general rule, if you find evidence of civil or criminal wrongdoing, does NFA report this activity to CFTC or to appropriate State or Federal law enforcement agencies, or to both, and in what sequence?

Mr. WILMOUTH. We go to wherever we think is necessary within a matter of hours. I just finished talking to Chairman Phillips on the way out, and I think it was within a matter of an hour or an hour and a half after we determined the situation in California that we were in touch with the CFTC which came into play from an enforcement standpoint, and brought them to court, with our support and our testimony. So we work very closely with them. We would inform immediately any State authorities or Federal authorities, depending upon what the situation would be. When I say immediately, I mean literally within a matter of hours.

Senator LUGAR. Have you received any feedback from introducing brokers whose registrations are being processed by NFA? Are they satisfied with the registration process and have you made any response to their comments?

Mr. WILMOUTH. Well, in all candor, I think I have received possibly all together, I would estimate, a dozen phone calls or letters from individuals who are applying to be introducing brokers and who are saying, in effect, your process is too slow; speed it up. I think the report that I just gave you a few moments ago indicated that we are 100 percent on top of this situation.

I might say that initially the task was far greater than we or the CFTC anticipated. The CFTC asked us to take on the registration of introducing brokers before our computer system was put into effect. We did it manually. I think that we have done an excellent job. I would point out to you again, 993 received; 175 registered; 166 voluntarily withdrawn; 50 sent to the CFTC; 136 awaiting clearance from a Government agency, or our own internal staff, but, most importantly, 374 of those applications, as of today, are deficient. We have said to them, "We need a return fingerprint card because it is smudged. We need signatures on your applications. We need the names of the principals. We need financial data", et cetera. So the burden, I feel, is now on them. And, once they respond to those deficiency letters, we answer within 24 hours.

The day an application is received, the fingerprints go to the FBI, because that is a 4- to 6-week process. I think we are on top of it. We initially had, quite frankly, some problems. Part of the problem was the fact, and I think Chairman Phillips pointed this out, that some of these IB's had never been, in effect, businessmen before. They had been business solicitors. And when you ask them for information, for example, in a couple specific cases I remember that they needed an audit by a CPA, the question came back, "What is a CPA?" So it is difficult sometimes to deal with those situations. We were slow to start; we are now 100 percent on top of the situation, and I have no qualms about anyone picking up the phone and saying, "What is the status of my application?" and being able to tell them within a matter of minutes exactly where it stands.

Senator LUGAR. Is the totality of the registration work of NFA in this registration of 900 and some persons that you just mentioned, or is that a specific type of registration?

Mr. WILMOUTH. That is just the specific registration of introducing brokers. There will be well over 100,000 names eventually. We have loaded a number of those names into our computer file now, and we will be doing, what I call computer processing of the registration in order to speed it up and become more accurate. We started it yesterday. We have been loading the file for a month and now we are updating the file, but we are going to be doing some actual processing as of yesterday on any new applications that come in from introducing brokers.

Later on this year, we will take over pool operators, trading advisors, futures commission merchants and associated persons, which, of course, is the biggest category of those.

We would hope, Senator, to have everything on file no later than the end of the year.

Senator Lugar. Would you believe that as many as 100,000 persons are involved?

Mr. Wilmouth. About 105,000 entities, at our last count, and it probably is more than that now because we have not taken a dump from the CFTC onto our file of what has happened recently.

Senator Lugar. And these are not investors or traders. These are persons who have some function in making the market?

Mr. Wilmouth. These are commodity professionals. By and large, they are associated persons of FCM's. Merrill-Lynch, for example, may have 3,600 or 4,000 associated persons. And other smaller FCM's have smaller numbers. But that is the biggest number by far.

Senator Lugar. What is the present fee structure for NFA, and has the structure changed recently?

Mr. Wilmouth. The structure has changed dramatically recently in terms of the assessments on our members. We started out assessing our members in three different ways. Perhaps that is the best way to break it down.

We have a dues structure which has remained somewhat intact for futures commission merchants of $1,000 a year. We had a very complicated structure which was at least $1,000 a year and, in some cases, more, for pool operators and trading advisors. We have recently cut that and received approval from the CFTC. I think it can become effective April 1 to cut that figure for dues for CPO's and CTA's to $250. Introducing brokers have a different fee schedule, depending upon whether they are guaranteed by an FCM, which is lower, or whether they must meet their own minimum capitalization requirements.

In addition to that source of income, we receive an FCM assessment fee, which was 33 cents for a round turn and has now been reduced, again subject to CFTC approval and, hopefully, effective April 1, to 28 cents a round turn. We were able to build up a sufficient cash reserve to allow us to withstand the vagaries of volume in the futures markets, both total volume and public participation volume. So we are able to reduce that fee. And the other thing that we did, we reduced the voluntary assessment fee on the part of the exchanges. It was 2 cents a round turn, maximum $300,000; minimum $25,000. That has now been reduced to a maximum of $150,000 for the two exchanges that have two members on our board and a maximum of $100,000 for an exchange who has one member on our board, plus, and it is now calculated at 1 cent a round turn, which means that those who were paying the minimum of $25,000, some of them are paying as low, in one case, if you use last year's figures, as about $3,374.

Senator Lugar. What role does the NFA anticipate playing in the regulation of leverage contracts?

Mr. Wilmouth. We have sent a team of people out to visit one of the leverage dealers, and have been in contact with another leverage dealer and have spent a good deal of time discussing this subject with the CFTC.

It was the CFTC's decision, and I might add, in our opinion, a very wise one, that they would begin the initial regulation of leverage contract dealers. They may decide to continue it. They may decide to ask us to do it. And we have stayed on top of it so that when the time comes we can respond appropriately. Depending upon what experience they have gathered, they will determine what role we would take. But we work cooperatively with them to listen to whatever they would like us to do to see if we can accomplish their objectives.

Senator LUGAR. What is the general feeling, as you can best characterize it, of the industry toward the NFA? Is there a feeling that the hopes the industry had for NFA have been fulfilled? What kind of feedback do you have from your constituents?

Mr. WILMOUTH. Well, I think I would have to tell you, with all due modesty, that I think the support of NFA is superb. The Futures Industry Association, which by and large has the biggest representation in the membership, has been totally supportive of us, and has indicated to us that they feel we are doing a very competent job. The National Association of Futures Trading Advisors, which takes care of the commodity pool operators and trading advisors, has also been very supportive of us. We have worked very closely with them. And you might ask their representative about their feeling with respect to NFA, but I would again say that from what they have told us, they feel very confident about what we have done, and confident of our ability to make our deadlines and to undertake and perform satisfactorily all of the targets that have been set forward for us.

I think the CFTC, as evidenced by Commissioner Hineman's remarks, and I think Chairman Phillips said the same thing, is again pleased with what has been accomplished by NFA. I think we have built an exceptionally fine staff and that, in effect, is the answer to success. Qualified people who are willing to do the job.

Senator LUGAR. Without being redundant, it appears that you have been processing registrations from persons who are unacquainted with the CPA, that some of the fears, I suppose of both professionals, as well as legislators, that many people were engaged in this business that were not very sophisticated have been well founded.

Do you have a feeling that the safety net is getting stronger; in other words, a current canvas of all of the players in the drama that we are getting a pretty good idea who they are and elevating the standards in a way that would bring greater confidence from the public?

Mr. WILMOUTH. I do not think there is any doubt about that. I think, first of all, the very existence of NFA has led to a reduction in the number of people who are registered as; for example, commodity trading advisors with the CFTC. They felt that since they had to pay NFA some dues that it was not worthwhile joining. So we lost a lot of members who had no interest, first of all. Second, a lot of them merely registered for the sake of being able to at least, in my mind, have a letterhead which said John P. Jones, commodity trading advisor registered with an agency of the U.S. Government on their letterhead. They have dropped out.

Those people with whom we have worked have, in most cases, I think, wanted to stay in the business, have needed some advice and guidance that we have been able to give them in terms of helping them set up their books and so forth and so on. But I would have to say I think we have weeded out some of those people who, you know, really did not want to be in the business, were not actively involved in it, or who were afraid of additional self-regulation from the NFA on the various activities they were performing.

One problem still remains. The one difficult problem is that if someone advertises themselves in a storefront in Dubuque, Iowa, and starts getting on a bank of telephones to call people in Dubuque, Iowa, and asking them to invest in the futures markets, and is not registered with the CFTC, and is not a member of NFA, he eludes the net so as to speak, but it is our feeling that with an intense educational program, with more of an awareness on the part of the general public about National Futures Association, people will then begin to ask questions such as, "Do you belong to the NFA?" And we are preparing and have already put out a couple of pieces of literature. We will have more out in the next several months on this area. So the net is beginning to tighten, I think.

Senator **LUGAR**. I want to thank you very much for coming and for your testimony. It was comprehensive, as always. We will look forward to return appearances as we continue oversight in the subcommittee.

Mr. **WILMOUTH**. Thank you very much.

Senator **LUGAR**. Thank you for coming.

Our next panel consists of Alan Brody, president, Commodity Exchange, Inc., New York, N.Y., and William Brodsky, executive vice president, Chicago Mercantile Exchange, Chicago, Ill. Welcome to you both.

We will be pleased to have your testimony. First of all, Mr. Brody and then Mr. Brodsky, and then I will address questions to you.

You may proceed.

STATEMENT OF ALAN BRODY, PRESIDENT, COMMODITY EXCHANGE, INC., NEW YORK, N.Y.

Mr. **BRODY**. Thank you very much, Senator.

As you indicated, I am Alan Brody, president of the Commodity Exchange, in New York. We are also known by the short name of COMEX.

I am grateful for this opportunity to testify on the Commodity Futures Trading Commission's implementation of the important amendments in 1982 to the Commodity Exchange Act.

I have a written statement which, with your permission, will be submitted, and I will proceed.[1]

Senator **LUGAR**. It will be published in full in the record, if you will proceed with your summary.

Mr. **BRODY**. Thank you.

As you know, COMEX is a futures market in New York City that has served the trading and hedging public for some 50 years. Our products include not some of the agricultural commodities that were referred to earlier in these hearings, but, rather, gold, silver, copper, aluminum, and in the CFTC's options pilot program, an option on gold futures.

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[1] See p. 109 for the prepared statement of Mr. Brody.

In 1983, COMEX's volume exceeded 20 million futures contracts, placing it first among the metals exchanges.

As these figures attest, COMEX has much at stake in assuring that the Commodity Exchange Act works well, and that the Commission fulfills its mandate in an effective and responsible manner.

These hearings will, and have already, covered a large number of subjects. Some of them can be addressed better by other witnesses that relate to issues that do not impact directly upon exchanges.

I would like to offer you my views on three specific topics in my summary. They are the CFTC's performance under the new procedures for contract market designations and exchange rule approvals; the Commission's regulation of leverage transactions; and the role of the States in the eradication of off-exchange fraud.

First, with respect to the contract market designations and rule approval amendments: As you know, the 1982 amendments to the act were designed to streamline the Commission's process for approving new futures contracts, and for reviewing other rules that the markets wish to adopt from time to time. The amendments also set forth certain timetables within which the Commission must complete its tasks.

In our view, in the months since those amendments became law, we have been generally pleased with the Commission's performance under them. We have found the Commission to be receptive to our and the industry's needs without sacrificing its duties in any way. There are occasions, occasionally, when the Commission's staff, in our view, seems unduly preoccupied, shall I say, with minor things, or inconsequential details, but, in the main, we believe that the amendments have worked well.

Proceeding on with respect to the regulation of leverage transactions, which have been discussed several times already today:

Leverage contracts, as you know, are off-exchange instruments that COMEX does not trade. Leverage contracts tend to be long-term agreements allowing customers to invest in various commodities through private companies as long as they maintain a certain minimum deposit and pay periodic carrying fees to the leverage merchant.

A number of leverage merchants offer instruments in precious metals and, therefore, can affect the public's attitude toward all forms of investment in precious metals. Ever since the earliest off-exchange scandals, therefore, COMEX has been concerned that neither the futures industry nor the Commission nor COMEX become identified in the public's eye with peripheral types of business unless they are subject to the strictest possible regulation.

Any business where one party can set the price unilaterally, where the contracts are not guaranteed by a third party such as an exchange's clearing organization, and where there is no public resale market for the contract, seems to us to be more troublesome than activity that takes place on competitive markets under the watchful eye of both a self-regulatory organization and Government authorities.

For these reasons, COMEX has encouraged the Commission to develop and enforce a system of rigid regulation for leverage transactions. At a minimum, these regulations should take into account the customer's lack of bargaining power when it comes to both the prices charged and the terms imposed, as well as a customer's right, without high-pressure sales tactics, to know what his real chances of making a profit are.

The Commission, as you have heard already today, has issued interim regulations which address some of these concerns. It has also most recently requested comments on further changes in leverage regulations, one of which would allow merchants to offer contracts that reverse the role of the parties and obligate a customer to deliver the commodity to the merchant. Since most customers cannot realistically be expected to have that ability, and this type of "short" leverage contract, if you will, is very similar to the futures contract, we hope that the Commission will exercise very special caution before allowing that practice.

Now, finally, with respect to the so-called campaign against criminal fraud:

Congress has repeatedly determined that futures trading should be governed by a single, centralized, consistent body of rules. As a result, the Commission has exclusive jurisdiction over exchange activity. COMEX believes, of course, that this arrangement is correct and that the history of Commission regulation since 1974 is conclusive proof of that.

But criminal fraud perpetrated away from the exchanges is another matter entirely. Here, cheating the public is not merely the result of an occasional errant employee. It is the career of full-time professionals who prey on the despair, sometimes naivete or greed of others. These criminals commit fraud wherever easy money can be made. This year, commodities may be their target. Last year, it might have been land sales or securities, or mail order merchandising. Next year, it might be tax shelters or oil and gas leases.

The important point is that these operators cannot be treated like legitimate business people. They will not submit to being licensed. They will not file reports with anyone. No investigator is allowed to pass through their doors. In short, these operators cannot, and will not, be regulated by the Commission or anyone else.

COMEX is aware of interest in some quarters of Congress to somehow deal with the problem through Federal regulatory agencies, such as the Commission. We cannot agree with that approach. First of all, it makes no sense for the Commission to "regulate" what is already clearly illegal.

Second, the Commission lacks the only tools that matter here: the power to arrest and imprison the offenders. And, finally, the Commission's resources are already fully committed to something that benefits rather than threatens society, that being fair and efficient futures markets.

One of the greatest accomplishments of this subcommittee and of Congress in 1982 was to empower genuine crime-fighting agencies, such as the FBI and the Department of Justice, and State law enforcement units to lead the campaign against criminal fraud. The criminal justice system is the only effective answer to this problem. And we applaud Chairman Phillips and her colleagues for their renewed efforts to involve other Federal and State agencies in this battle. I can assure you that COMEX also stands ready to provide whatever assistance it can in this battle.

In conclusion, let me just summarize that COMEX believes that the provisions of the 1982 amendments affecting it are working well. Our concerns, as indicated in my remarks, are in the off-exchange area where the Commission must be especially vigilant. If that activity can be regulated at all, it must be policed rigidly. And, where hard-core crime is involved, strict criminal law enforcement by agencies with the power to arrest and imprison is the only effective way to protect the public.

That is the conclusion of my remarks, Senator. I would be pleased to answer any questions now or, if you prefer to wait for Mr. Brodsky.

Senator LUGAR. Thank you very much, Mr. Brody. I will ask Mr. Brodsky to testify and then, if I may, I will ask questions and both of you may have comments.

STATEMENT OF WILLIAM BRODSKY, EXECUTIVE VICE PRESIDENT, CHICAGO MERCANTILE EXCHANGE, CHICAGO, Ill.

Mr. BRODSKY. Thank you, Senator.

Senator Lugar, I have with me Jerrold Salzman, who is general counsel to the Chicago Mercantile Exchange.

Senator LUGAR. We are pleased to have you, sir.

Mr. BRODSKY. Senator, I would like to summarize my formal testimony. I will ask that my prepared statement be made a part of the record.[1]

Senator LUGAR. Your testimony will be published in full in the record.

Mr. BRODSKY. Thank you.

We agree with Mr. Brody's comments that the CFTC has performed its role diligently and efficiently since the enactment of the 1982 amendments and, in fact, since its creation. Our comments, however, are limited to your request for information on the performance of the Commission under the amendments. While we do have legitimate arguments with certain CFTC activities, our objections result from the necessary performance by the CFTC of statutory duties that are imposed by the legislation.

My remarks are limited to four issues: The contract approval process; rule review; industry studies, and the options program.

With respect to the contract approval process, we believe that the 1-year time limit, which sometimes has seemed like an eternity, has worked well. We have a complaint. We believe that the CFTC's power to delay approval of contracts, by deeming a contract deficient when, in fact, contract is not deficient, may be used as a lever to extract from the exchanges acquiesence to changes in the contract. Many of the changes sought are market judgments, and have nothing to do with the essence of the contract. The statute, at section 5(g) states that a contract must not be contrary to the public interest. But there is no definition of public interest nor is there any recognized standard for such definitions. The statutory requirement that the contract be in the "public interest" creates a problem because the CFTC staff is forced to test a proposed futures contract against a vague "public interest" standard. This forces the staff to make judgments which we believe are best left to the contract market, which has the most to lose if a contract serves no legitimate purpose.

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[1] See p. 113 for the prepared statement of Mr. Brodsky.

The contract market has its resources and prestige on the line when proposing a contract. If the contract meets the statutory standards respecting manipulation, delivery standards, et cetera, the Commission's staff should not be the ones to say that there are terms of the contract which could better serve the "public interest" and, hold up the approval of the contract. Because of the tremendous competitive pressures, both within the futures industry and within the securities industry, the exchanges very often accept the CFTC's suggested changes because a fight means a loss of valuable time in this competitive arena.

With respect to rule submissions, Congress has restricted the mandatory approval process to rules which relate to the terms and conditions of a contract. However, the CFTC was granted power to define "terms and conditions." The CFTC abused its power to define "terms and conditions" in order to broadly expand the reach of its rule reviews in derogation of Congress' intent. Congress also provided that the decision to review certain rules in advance of their effective date could not be delegated. The Commission, however, has effectively delegated to the staff the ability to determine which rules are subject to discretionary review by giving the staff the ability to select which rules are not be be reviewed.

We also object to the Commission's assertion of authority over option margins. We believe that the grant of authority over option trading was not intended to give the Commission the authority to set the level of margins. The statute explicitly denies the Commission that power.

While I am on the subject of options, let me just skip ahead to my last topic

The 1½ years of experience with exchange traded options on futures have been very positive. Prior to CFTC regulation, the reputation of commodity options was extremely negative. That reputation grew out of abuses in selling and pricing of off-exchange options. That reputation led, and correctly so, to the pilot program which is now in place. The experience to date has been positive. The Commission's sales audits confirm the integrity of the program. We hope that the Commission will look favorably upon our request, which was made over a month ago to review whether that pilot can be expanded in the nonagricultural area.

We are the only exchange trading an option on two of our futures contracts. I am happy to say, with over 1 year of experience with one of them and a few months on another, that they are working very well and that the concerns about customer abuse do not appear to have been well founded.

Lastly, with respect to studies, I think it is fair to say that this industry is, has been and continues to be studied to death. And while I do not think that that, in and of itself, is bad or wrong, our concern is that when studies are required or requested that they be clearly defined in the first place. We think that authorizing a study without sufficient prior thought creates an awful lot of work, and an awful lot of expense, to the Government as well as the industry. An ill-conceived Government study leads inexorably to an industry study by an independent economic expert. There are studies in progress by the Federal Reserve Board, the Bush task force and two more by the CFTC. Most recently and surprisingly, the Government Accounting Office, at the request of Congressman Wirth is studying the securities industry and, to our surprise, the GAO investigators have come in to see us; the NFA and I believe some other futures exchanges in connection with that study. There are substantial costs involved in terms of executive time and financial resources that have to be brought to bear to supply information and participate in interviews. The duplication of studies causes significant waste.

That is the end of my summary of my formal remarks. If you have questions, I would be happy to answer them also.

Senator LUGAR. Thank you very much, Mr. Brodsky. I comment, just parenthetically, following your remarks about the studies, that, indeed, you may remember during the conference of the Senate bill with the House bill, in the latter days of 1982, the number and the extent of the studies proposed particularly by our colleagues on the House side were truly remarkable in scope and expense. And it was the position of this Senator, as a conferee, to attempt, on behalf of the general public, to pare down millions of dollars that were being proposed for extraordinary endeavors.

I think the studies that we have come to in the legislation as compromises are reasonable efforts, and I appreciate the difficulties that are imposed, but I suppose, from the Senate side, we would plead some forbearance, with recognition of what might have been. There may be some benefit from these studies. I have no doubt, as I am reassured, and you are, by Chairman Phillips today that we are progressing at the end of this fiscal year to at least find the conclusions of those studies. So those will be available to the industry and the public and they may serve as an oversight in their own right.

Let me raise these questions and ask either of you or both of you to comment as you feel that you wish to.

The reauthorization legislation formalized the exchange's responsibility for the implementation and enforcement of speculative limits. What has been your experience in this area, and are the speculative limits adversely affecting market liquidity?

Mr. BRODY. Senator, in my opinion, the situation relating to speculative limit has worked very well. We at COMEX have thought for at least several years now that position limits are a vital self-regulatory tool for an organization such as ours. And we have been working, of course, with the CFTC pursuant to its regulations and have adopted, of course, position limits which are now in effect.

In my opinion, the position limits have generally not affected market liquidity. So, as I say, the situation has worked well. The only criticism that I might offer is, of course, that markets change. Markets grow. Markets sometimes shrink. And the ability of an exchange to either expand or retract its particular speculative limit in a short period of time is necessary. That is one area where I think the exchanges and the CFTC need to work better together to make sure that, for example, the review process for rule changes in connection with speculative position limits is perhaps expedited.

Senator LUGAR. Mr. Brodsky, do you have a comment?

Mr. BRODSKY. I would ask, if you do not mind, Mr. Salzman to respond to that, since he was our prime worker with the CFTC on the speculative limit area.

Mr. SALZMAN. Prior to the amendments, we used speculative limits in connection with policing of agricultural markets. In such markets, we felt the need to assure a proper balance between deliverable supply and the number of positions controlled by an individual. We were, as an exchange, less concerned in the financial instruments area particularly foreign currencies where it appeared that the immense deliverable supply would preclude an adverse market impact relating to large positions. Thus, we believed that speculative limits were not a relevant tool.

Even prior to the amendments, we had policies in place in regard to our agricultural contracts that met congressional concerns. We had adopted policies that lower speculative limits as the delivery month approached. In many cases, we required hedgers to reduce large positions near the close of the delivery month, regardless of their legitimate status or hedgers.

These limits in agricultural contracts probably limit liquidity of those markets, but we made that choice as a method of fulfilling our self-regulatory duties. We are prepared to sacrifice liquidity because we are concerned about the size of deliverable supply and we hope to preclude undue congestion in the market.

The financial contracts are different. The exchange never believed that limits were necessary to perform its self-regulatory duties. Nevertheless, at the CFTC's urging, we have adopted limits. In one or two cases, those limits have impaired liquidity because the users of financial markets deal in numbers that are staggering to the imagination. However, since the supply is even more staggering we have never been concerned. There has never been a problem in those markets, but commercial enterprise right to use futures markets has been slightly impaired by limits on the financial contracts.

Senator LUGAR. The industry that you gentlemen represent this afternoon, your comments, continues to experience very significant growth. What actions have the exchanges taken to beef up their own enforcement procedures in order to keep pace with that growth and have the resources you are devoting to this cause increased substantially?

Mr. BRODY. Senator, if I could start, the only way that I could answer that from an exchange perspective is you are quite right, our industry has grown dramatically in the last several years and it continues on an annual basis. Our response, as an exchange and as a self-regulatory organization, is to genuinely increase substantially our internal compliance and other resources to deal with that. I maybe should have brought the figures with me, but our own personnel has grown dramatically as well as the amount of funds and expenditures we commit to compliance, rule enforcement, and other self-regulatory obligations that we have.

Senator LUGAR. Could you supply that data for the record at a later point?

Mr. BRODY. Certainly.

Senator LUGAR. I would appreciate it. It would help us have a more complete record.

Mr. **Brody**. I will be happy to.

[The following information was subsequently received by the subcommittee:]

Comex,
New York, N.Y., April 9, 1984.

Senator Richard G. Lugar,
306 Hart Senate Office Building
Washington, D.C.

Dear Senator Lugar: I appreciated the opportunity to appear before the Senate Agriculture Subcommittee on Research and General Legislation on March 15.

Commodity Exchange, Inc. ("Comex") is always eager to present its views on issues relating to our industry. As I testified, Comex is generally pleased with the work being done at the Commodity Futures Trading Commission.

As you requested, I have enclosed figures showing the increase in personnel and budget for our Compliance Department and rule enforcement function, which demonstrate Comex's increased commitment to its self-regulatory responsibilities as a consequence of the growth of our business. Please let me know if I can be of additional assistance.

I look forward to working with you and your subcommittee in the future.

Very truly yours,

Alan J. Brody,
President.

Enclosure.

	1980	1983
Compliance:		
No. of Personnel	23	34
Budget	$599,398	$1,076,190
Legal: [1]		
No. of Personnel	2	7
Budget	$515,867	$575,772
Market [2] surveillance:		
No. of Personnel	2	4
Budget		
Totals:		
No. of Personnel	27	$1,631,133
Budget	45	$2,820,956

[1] This budget reflects the amount expended for the compliance function of the Legal Department.

[2] Since the budget for this department is included in the budget for the Research and Market Development Department, exact figures cannot readily be extracted.

Senator **Lugar**. Mr. Brodsky?

Mr. **Brodsky**. I would like to add, Senator, two things that I think are very important. One, it is a question of the quality of people, and a good plan. I believe that is something that our record has been demonstrated in terms of our CFTC oversight examinations over the past few years, and particularly in the last year or two.

And, second, we are tending to rely more and more on automation. I do not think that the effectiveness of self-regulation can be measured by the numbers of personnel or the size of the budgets. I think that the future belongs to automated information retrieval and processing. We are using our computers in ways that highlight potential problems. Work that formerly required 10 clerks and 1 analyst is now performed by a single analyst.

Our business has become more financially oriented. Our volume is now between 75 and 80 percent in financial futures and options. The nature of the surveillance is different and in many respects easier than it has been in the agricultural area.

Senator **Lugar**. The CFTC now charges $10,000 as a fee for a contract market designation. Has this fee created a problem for the exchange?

Mr. **Brody**. Senator, certainly not for us. We supported the notion of that fee. We were, and still are, of the view that the CFTC needs money, needs recources, and it is appropriate for the Commission to charge a fee for the contract market designation process. And I do not believe it has worked adversely, at least, in my opinion.

Mr. **Brodsky**. The fee has some favorable impact because it prevents frivolous filings with the Commission and, therefore, gives the staff of the Commission the freedom to spend more time on those contracts that are most important.

Senator **Lugar**. In your testimony, in particular, Mr. Brodsky, you commented about the 1-year limit on filing an application and approval. Of course, as you will recall, this was a major focus of the hearings and the markup debate, and you have come to a conclusion that that has been a step forward and it has worked well, although you made some additional comments about the CFTC's review, and various pressures might be applied in that respect.

Is it the view of both of you gentlemen that the industry, as a whole, shares a feeling that procedures have been expedited and that at least the agreement, or compromise or how ever one would characterize the language that we came to at that point, has been a reasonable solution?

Mr. **Brodsky**. I would think it has been, yes.

Mr. **Brody**. Senator, I would agree with that. I think industry-wide that perception exists.

Senator **Lugar**. What efforts are being undertaken by the exchanges to promote ag options? In the case of COMEX, maybe none and you would not be involved in that, but I will not preempt your answer; and the second part, to educate farmers on the usefulness of those options and on other activities of the exchanges.

Mr. **Brody**. Senator, if I might say, if one defines agriculture as something which grows or comes out of the ground, COMEX's public posture has been perhaps that copper may constitute an ag option. But you are quite right, we do not have an interest, so I would defer to Mr. Brodsky.

Mr. **Brodsky**. I can echo some of the comments made by Commissioner Hineman earlier today. I think that the product has a tremendous potential, though I would not expect it to show very rapid growth in the early stages. I believe that education is a critical element in the farm community for this new product.

We already have an educational booklet in print and available for distribution to that constituency. And I would expect that we will begin seminars well before trading opens.

I had 10 years experience in the securities options business before joining the futures world, and I truly believe that the option product is a very significant adjunct to this industry. Properly handled, options could attract participants who need price insurance but have avoided for many reasons historically, futures contracts.

Senator **Lugar**. I appreciate your comment. Once again, historically, you will recall that this particular product was not available and, in fact, the experience in the 1930's, which was reviewed during the hearing for reauthorization, showed many flaws and great anxiety, and many people shared that a half century later. So the committee, and in due course the Congress, in authorizing this new approach, shares, I suppose, some risk. But, at the same time, it appears from the testimony of CFTC and the special efforts of Commissioner Hineman, that a considerable educational effort is underway. And I appreciate the additional comment you have made about the work of your exchange in making educational materials available.

Mr. **Brodsky**. We will back that up with seminars and onsite appearances by our own people. We will have a whole complement of people out in the field giving seminars and be able to answer questions on the phone.

Senator **Lugar**. I thank you all for coming this afternoon. You have been most helpful in your testimony.

Mr. **Brody**. Thank you, Senator.

Senator **Lugar**. The Chair will call now a panel: Theodore Thomte, director of the National Association of Futures Trading Advisors, Boston, Mass., and Robert Isaacson, director of the National Association of Futures Trading Advisors in San Francisco, Calif.

Gentlemen, welcome.

Mr. **Thomte**. Thank you, Senator.

Senator **Lugar**. As with the previous witnesses, I would ask, if possible, that you summarize your prepared testimony, preferably, in a 5-minute period, and with assurance that your entire prepared statements will be made a part of the hearing record. Then, after both of you have testified, with Mr. Thomte first and Mr. Isaacson second, we will proceed to questions.

Mr. **Thomte**. With your permission, Senator, if Mr. Isaacson could start and I would take it second.

Senator **Lugar**. Very well.

Mr. Isaacson.

STATEMENT OF ROBERT ISAACSON, DIRECTOR, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, SAN FRANCISCO, CALIF.

Mr. **Isaacson**. Thank you.[1]

I am a director of the National Association of Futures Trading Advisors. We are a national trade association, consisting of commodity money management professionals.

NAFTA has 175 members, who manage approximately $800 million in commodity investments. We have something over 5,000 clients.

Our members are active as commodity trading advisors and commodity pool operators; they operate or advise a substantial number of the pools and managed commodity accounts.

NAFTA welcomes this opportunity to report to the committee on the experience of its members in operating under the current regulatory structure governing the futures industry. We are pleased to report that the National Futures Association has fulfilled the expectations of the futures industry regarding self-regulation. The development of NFA and its assumption of growing responsibilities over the past 18 months have to a great extent made regulation more efficient and more protective of the public interest.

Among the accomplishments of NFA that NAFTA deems particularly noteworthy are its registration of introducing brokers and their associated persons, its establishment of new and workable arbitration procedures, and its development of a thorough ongoing audit program for NFA members, including advisors and pool operators.

NFA has implemented its program for registration of introducing brokers and their associated persons in an efficient and satisfactory manner. Registration staff are accessible and knowledgeable.

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[1] See p. 124 for the prepared statement of Mr. Isaacson.

As NFA expands its registration duties, testing requirements will be established. NAFTA welcomes this development as a means of enhancing professionalism within our industry.

We are working with NFA staff to develop tests for the associated persons of pool operators and trading advisors. These tests will be custom made for the categories of applicants for registration. As a result, applicants will be required to demonstrate a working knowledge of the legal and compliance requirements pertaining to their activities.

The development of the NFA arbitration program is another promising aspect of NFA's growth. NAFTA believes that as the availability of this forum for dispute resolution becomes more widely known, it will provide a popular alternative to litigation and arbitration in other forums. The average time for resolution of a dispute through NFA arbitration is significantly shorter than that for litigation. In addition, the costs of NFA arbitration are generally far less than those entailed in litigation.

Another indication of the favorable industry response to the availability of NFA arbitration is the number of industry members who have volunteered to act as arbitrators on NFA panels, as Bob Wilmouth mentioned.

We feel they constitute a unique pool of futures industry expertise.

A third area of NFA accomplishment, and probably more important to advisors than pool operators, involves the NFA's comprehensive audit program. Although this audit function could be performed with only a narrow focus on going in and reviewing books, NFA audits have concentrated on member education as well.

Many NAFTA members are relatively small pool operators or trading advisors. These members have been assisted by NFA staff in implementing changes in recordkeeping and reporting procedures, and in modifying their disclosure documents to conform to applicable CFTC and NFA requirements.

NAFTA believes that an essential element of industry self-regulation is education of members as to their regulatory and compliance responsibilities because a large percentage of technical violations arise from incomplete understanding of applicable rules. NAFTA specifically wishes to acknowledge the assistance received by NAFTA members from NFA staff in developing and improving their compliance procedures.

NAFTA also believes that industry self-regulation requires a concentrated effort by industry members to identify those among them who fail to comply with the standards established for the conduct of all members, and to institute appropriate corrective actions.

NAFTA members have from time to time informed NFA of examples of misbehavior by industry members. NFA staff have acted promptly on these suggestions and have initiated audits or investigations of members whose business practices have been questioned.

The particular examples of NFA performance cited in our testimony should underscore a development viewed by NAFTA and its members as having even more important longrun consequences; the development of an effective working relationship between NFA and the industry that it regulates. This relationship between NFA and the industry is characterized by a high degree of mutual respect, a willingness to understand conflicting viewpoints and a desire to accommodate them where possible. NFA accomplishments since its inception have been made possible by a working environment conducive to effective self-regulation.

Thank you for your attention. I will be happy to answer any questions.

Senator LUGAR. Mr. Thomte.

Mr. THOMTE. Thank you, Senator.

STATEMENT OF THEODORE THOMTE, DIRECTOR, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, BOSTON, MASS.

My name is Ted Thomte. I am a director of the National Association of Futures Trading Advisors, and I serve as chairman of NAFTA's Government Relations Committee.[1]

I would first like to endorse the comments of my colleague, Robert Isaacson, concerning NAFTA's general satisfaction with the efforts of the CFTC and of NFA in regulating the futures industry, particularly the highly specialized segment of the industry comprised of advisors and pool operators.

To an unusual degree, these agencies as well as the State regulatory authorities have succeeded in coordinating their regulatory program to the benefit of both the public and the industry.

An important example of regulatory cooperation is that of the CFTC, NFA, and the State securities agencies developing an enforcement program directed at off-exchange commodities fraud. The CFTC, NFA, and the North American Securities Administrators Association, known as NASAA, has strengthened investor protection by their joint enforcement activities, as mandated under the 1982 act.

However, NAFTA is compelled to draw to the committee's attention one area where the mandate of the 1982 act has been systematically ignored. The States, through NASAA, have persisted in their attempts to regulate the substance and structure of commodity pools, despite contrary intentions repeatedly expressed by the Congress.

On January 1, 1984, new guidelines for the registration of commodity pool programs were promulgated by NASAA. These guidelines specify in detail the permissible structure of publicly offered commodity pools. As such, the guidelines are contrary to the philosophy of full disclosure incorporated in both CFTC and Federal securities regulation applicable to commodity pools.

As a result, the development of new types of pool structures have been inhibited, and marketplace competition among products has been replaced by arbitrary and ill-informed judgments by regulatory authorities whose knowledge of the futures industry is limited because they do not regularly oversee commodity pools.

These State guidelines are contrary to the intent of Congress, a fact that is clear from the legislative history of every major piece of futures legislation adopted in the past 10 years. From our point of view, the significant problem is that because of the expense involved in challenging these guidelines in court, industry members necessarily have not attempted to block their application.

This issue was generally discussed and extensively covered during the 1982 CFTC reauthorization hearings. At that time, the committee expressed its view as clearly. I am quoting from the record and I will not go through this in great detail as it is in our printed remarks. The basic thrust was that Senator Helms had offered an amendment such that "the provisions of this act shall preclude the qualification or substantive regulation of commodity pools under the various laws of the several States * * *"

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[1] See p. 128 for the prepared statement of Mr. Thomte.

It was decided that that amendment would not be included in the act because the view of the committee was that the law was clear on that matter.

As industry participants, regrettably, we find that that is not the way it works for us. We thought that, indeed, the law was clear. We think the committee and the legislation was clear on this matter, but there is a substantial difference between NASAA guidelines as they impact us as businessmen, and the way that we view this system should operate, and the intent of the Congress.

I have quoted in my remarks in some detail from that record, but we think that record is quite clear.

To summarize that, the Conference Committee Report accompanying the Futures Trading Act of 1982 clearly incorporated the views that were expressed at the time.

> The conferees intend that nothing contained in this provision will permit any State to impose, or to initiate any suit, action, or proceeding for an alleged violation of any State licensing, registration, or qualification requirement provided for under any State securities or commodities statute. Similarly, nothing in this provision permits any State to initiate any suit, action, or proceeding against a person registered under the act for an alleged violation of any rule, regulation, guideline, or statement of general policy issued under any State securities or commodities statute.

NAFTA is concerned about the impact of NASAA's continued disregard of the intentions of Congress. We urge the committee to take steps to assert more forcefully the will of Congress that the States have no role in the substantive regulation of commodity pools.

At this point, I want to emphasize that NAFTA strongly supports the State enforcement authority, authorized under the Commodity Exchange Act, and we believe the States have an important role to play in enforcing provisions of the act.

In summary, with the exception of the State pool guidelines, NAFTA believes that the agencies responsible for regulation of the futures industry have diligently discharged their responsibilities and have created a regulatory framework that is at once workable to industry members and protective of the public.

NAFTA is especially appreciative of the CFTC's action in designating a special counsel for regulatory matters affecting pool operators and trading advisors, an action that we believe is generally symbolic of the CFTC's recognition of the highly specialized nature of our area of the futures industry.

Mr. Isaacson and I were over visiting at the Commission this morning and, once again, the Commission's commitment in that area was reemphasized to us in those meetings. We look forward to continued contact, and we think that their designation of a particular attorney on their staff, who is knowledgeable in this area, to deal with these matters will be helpful both to the Commission, to the industry and, more importantly, to the general public in dealing with some of the problems that come up from time to time.

We appreciate the opportunity to appear before this committee and we would be happy to elaborate our views to members of the committee or the staff.

Senator LUGAR. Gentlemen, thank you for your testimony.

Would you give a comment as to what you believe the remedy might be to the criticism that you have made of State participation in the regulation of pools?

Mr. THOMTE. I think, Senator, there is a fundamental difference of opinion between our views and the States' on these matters. We think that merit regulation, as it is called, is inappropriate in this area. As businessmen, we would prefer to deal with one comprehensive body of regulation. We believe that is in existence with the CFTC regulations, now substantially reenforced by NFA, with its audit procedures. Both Mr Isaacson and I are on the NFA board; we are both members of the NFA executive committee, in his case, representing commodity trading advisors and in my case representing pool operators.

As Bob Wilmouth testified, we now have a substantial degree of cooperation. And we, Mr. Isaacson and I, have very vigorously supported the interaction between NFA and the States. That is an enforcement matter. There is, fundamentally, a difference of opinion between State regulators and members of the industry on this matter of merit regulation.

In our view, there is comprehensive Federal regulation. In our view, with the advent of NFA, there is now reenforcement of structures that will put bad guys out of business, quickly.

Our view may be irreconcilable. We think the Congress has considered that matter, considered it repeatedly, and we still see that problem cropping up continuously.

Senator LUGAR. My question was really what is the remedy? Is it your suggestion that Congress must act again legislatively? Or is there any way of differentiating between these points of view in something other than a legislative manner?

In other words, I gather that there is a conflict. We will have testimony shortly from maybe another point of view, but how can this be resolved?

Is it a subject in which the Federal law must be made more clear? Is there some method through CFTC? What suggestions do you have as to how we can come to grips with it?

Mr. THOMTE. I think many of the areas of disagreement have been whittled down by conversation and cooperation, so that the one area that is left open is this question of merit regulation. In our view, the Congress has been clear on this. But one thing that we might request of the committee is that the backbone of the CFTC on this matter might be stiffened.

We think the matter is clear. In this one small segment, we think the legislative history is clear, but that, of course, is our view. I know you will have testimony from the State administrator's point of view. I think that stiffening the CFTC's backbone is probably the best thing I could think of at this time. We continue to have channels of communication open, and I want to stress that we have good and building relationships in that area, but there is this fundamental matter of disagreement.

Senator LUGAR. Gentlemen, the Futures Trading Act of 1982 established the requirement that associated persons of commodity pool operators and commodity trading advisors register with the Commission. The Senators felt that someone should examine the background of these sales personnel before they were allowed to handle customers' funds. Proceeding from that, are not these account executives being registered, in your judgment, have there been any problems associated with the registration process?

Mr. ISAACSON. The registration process, as I would view it and I think Ted would agree, is kind of evolutionary. When the NFA first started out, there were some problems with getting the procedures down, but those have been resolved. And we are in the process of working with NFA to develop a series of tests to determine if these sales persons are, indeed, qualified, and there is a whole different set of requirements for commodity pools. The answer is yes, they are doing their job.

Senator LUGAR. Do you have an opinion as to whether the registration requirements have reduced customer loss due to misconduct on the part of account executives?

Mr. ISAACSON. I think the NFA and the CFTC have both done a very good job of going out and finding fraud, and they have developed an atmosphere where those of us on our side of the regulatory scale call the CFTC and NFA if we see something that arises which is illegal. I think there are probably less people today trying to scam the public than there might have been 2 years ago.

Senator LUGAR. In your last answer, you indicated that you have tried to develop tests, or testing standards, to be used as a precondition for registration. As you say, is this an evolving process, or are you reasonably satisfied that you have such tests and standards now that would work?

Mr. ISAACSON. We have eliminated a lot of those people. The test is not developed yet. There was some controversy about the test and advisors and pool operators feel the things our people should be tested on, how to read a track record, and perhaps what are the different things that are supposed to be in a disclosure document; how would you interpret it. Those are the things that are going to be important.

Senator LUGAR. Are those elements going to be in the test?

Mr. ISAACSON. Yes, sir.

Senator LUGAR. Does the National Association of Trading Advisors have a system for monitoring sales practices of its members?

Mr. THOMTE. NAFTA is a voluntary organization, and NAFTA could be viewed as a trade association. We have, as members of the NAFTA board, discussed that issue a number of times, and it is one of the major reasons that we were so supportive of NFA. We had no mandatory membership requirements, and we felt—in that we lack policing powers—that that was an appropriate action for NFA, and we have been supportive of NFA in those areas. But NAFTA itself does not have the ability to accomplish that end. We do think NFA is becoming increasingly effective in that area.

Senator LUGAR. If NAFTA receives, or becomes aware of customer complaints, do you have a system for notifying the appropriate regulatory body, and have you had any experiences recently in doing that?

Mr. ISAACSON. NAFTA is similar to the FIA. Our customers, or NAFTA's clients would be the advisors and pool operators. I think each of us, as individuals, if we sense something, can call the CFTC or NFA. For example, on the west coast we recently had a problem, a fellow who had been ripped off by some people in the commodity industry. I suggested that he call NFA in Chicago and he went through the arbitration process with NFA, and received his money back. To that extent we do it as individuals, there is no formal setup within NAFTA to accomplish that. We have worked with the NFA and helped them set up a system where they both through Futures magazine and monitoring different newspapers throughout the year, and if they see ads that are particularly misleading, and they pick out ads that are particularly misleading, they will call those people and try to find out what they are doing.

Senator LUGAR. But you have no systematic process; this would be individual initiative to bring these difficulties to the attention of authorities?

Mr. ISAACSON. That is right.

Senator LUGAR. Have you experienced any difficulty since reauthorization working with CFTC or the State securities administrators? You have indicated at least one area, but you indicated also a good line of communication with State authorities. How about with the CFTC?

Mr. THOMTE. Yes. I think we are particularly gratified with the appointment of a knowledgeable staff person at the CFTC to deal with these matters. In talks with people at the Commission today, and other conversations recently, we have been given assurances that we can be involved in discussions of problem areas that the Commission perceives relatively early on. We think that is going to improve already good relationships. We want to stress that our view is that CFTC has done a very good job.

I think the testimony can give the sense, perhaps, that we are critical of the CFTC. I want to reenforce our joint views and NAFTA's views that CFTC has, by and large, done a very good job in this area, and we think the liaison is improving.

Senator LUGAR. In your opinion, what action by the NFA is likely to expedite their ability to assume more registration functions? Do you have any comments or counsel with regard to that question?

Mr. ISAACSON. They have undertaken a massive job. We are fairly privy to some of the things, being on the board. They have done an excellent job so far. I think it is just a matter of working through the procedures. I think the bulk of the problems in registration have come from those of us out there who have not filled out our forms correctly; we have not taken time to read through the forms. That balls up the whole system.

Senator LUGAR. As you have heard earlier testimony by Mr. Wilmouth, apparently many people attempting to fill out the forms are having these difficulties; as he suggested, some do not know what a CPA does, or has some fundamental difficulties. Has that been your experience, that there is a great deal of difficulty among persons who are less sophisticated in these things?

Mr. ISAACSON. CTA's and CPO's are basically small cottage type operations. I would say, if you are an average CPO or CTA with two or three people employed that would be a lot. And you get a mass of forms and it is difficult to sort through those, especially if all you had to do before was sign your name. You get adjusted.

Mr. THOMTE. We are seeing an education process. A number of people are dropping out of the industry. I think Bob Wilmouth's comments were mostly directed to introducing brokers.

Senator LUGAR. Yes.

Mr. THOMTE. And those folks had never seen any regulatory scheme imposed upon them before. But I think as people get more knowledgeable over time, it becomes less of a problem for all of the participants in the industry, and that is to the good of the public, and certainly to the good of the industry.

I would reenforce Mr. Isaacson's point on the small cottage industry nature of our field. They are small entities and we have had conversations with CFTC on that point. I think perhaps there was a mistaken perception by some at the CFTC staff that our industry is made up of firms that are larger than they are. My company has a dozen people in it, and we are considered one of the larger entities in our field. Mr. Isaacson's company has five people in it. It very much is a small business operation. We are having discussions with CFTC on that point, because I think there was the view, perhaps, that firms were larger than what they really are.

Senator LUGAR. I thank you both for coming today, for your testimony.

Mr. THOMTE. Thank you, Senator.

Senator LUGAR. The Chair would like to call now Philip Feigin, Colorado State Assistant Securities Commissioner, from Denver, Colo.; representing the North American Securities Administrators Association, Inc.

Welcome, Mr. Feigin. If you would proceed with your testimony, with a summary, hopefully, we will proceed to questions.

STATEMENT OF PHILIP A. FEIGIN, ASSISTANT SECURITIES COMMISSIONER, COLORADO DIVISION OF SECURITIES; AND CHAIRMAN, SPECIAL PROJECTS COMMITTEE, ENFORCEMENT SECTION, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Mr. FEIGIN. Thank you, Senator.[1]

I would first like to indicate that H. Wayne Howell, who is director of the securities division and also vice president of NASAA was here earlier, but had to leave for Kansas City, on other business.

Briefly summarizing, the developments that have been discussed today, the amendments to the Commodity Exchange Act, the leverage rule, the emergence and reenforcement of cooperative association between the CFTC and NASAA, and also the efforts of the National Futures Association have been very important in creating what we believe to be a new era of commodities regulation in the off-exchange field.

It is very important to note that, contrary to what we have heard in some of the other presentations this afternoon, the area that NASAA is concerned with is the off-exchange area. It bears about as much relation to exchange-related futures as earthworm farms and chinchilla ranches have to shares of IBM stock traded on the New York Stock Exchange. This is a much different area.

Some of the things about this field today, as far as the States go. we are emerging from an era, a decade where we were basically told to stay out of the area. This area has created a mood of resentment and abstention, I think, that we are trying to overcome this mood with our efforts which I will try to explain in a moment.

It has created a void; created a lack of expertise at the State level; lack of familiarity with the area and, at the same time, when many of these frauds were proliferating. We have a great deal of supply of things to do, and we need to strengthen our ranks to be able to do it.

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[1] See p. 133 for the prepared statement of Mr. Feigin.

This is occurring at the same time when we are faced at home with policies, basically, of deregulation, the era of anything you cannot taste, touch or smell being called a security is probably at an end, based upon recent court decisions. We are faced with budget and staffing cuts at the State level. And we are also facing a situation where few new laws or broader jurisdictional grants are being made.

Finally, with the 12(e) provisions, the so-called open season provisions, we are faced with a removal of preemption, but not necessarily a grant of jurisdiction. And we are faced right now with the problem of trying to find that these investments that we are, at least, allowed to regulate are within our jurisdiction. Are they securities? That is going to take awhile. We may also need a different approach if the securities approach does not work, and that would be in the area of the model act.

Meanwhile, there may be no one, no cop on the beat, and that is, I think, one of the largest problems. The definitional problems that are created or exist in the leverage area, in the other off-exchange areas, must be cleared up. It has a chilling effect in any regulatory agency as to whether to proceed; whether to spend limited resources on a case which may get thrown out of court on a technicality.

Also, there is a consistent State problem in that chasing exotic investment schemes is expensive, and our resources are limited to our borders. We cannot subpena California persons from Colorado. We cannot depose across our borders. And most of these frauds clearly are characterized by WATS lines and mass mailings, which are extremely frustrating.

As I stated in my written testimony, I think NASAA members have embarked on basically a three-pronged effort to meet the challenge, the first part being education. CFTC has presented, I believe, three seminars in the last 18 months or so, involving commodities fraud and prosecution. NASAA has provided funding for many State enforcement staff members to attend those seminars. We have also presented one ourselves in Minneapolis on the investigation and prosecution of a boilerroom.

Second, in the enforcement area, we have embarked, I think, on a very aggressive plan of trying to promote and organize enforcement efforts in member States. At this point, California is the key jurisdiction pursuing many of the so-called leverage or metals companies that have proliferated in southern California. In addition, it was a NASAA grant that assisted the New York attorney general's office in putting together the various authorities that resulted in the arrest of the organizers in the *International Gold Bullion Exchange* case, and it was also NASAA funding that allowed out-of-State discovery in the State of Arizona's action against a strategic metals dealer, that is going on right now.

So I believe we are trying to bring State enforcement actions again, using whatever tools are available, be it the Commodity Exchange Act, State securities laws or other State laws.

Finally, recognizing that a new approach might be needed, we have embarked with the NFA and CFTC on an attempt to solve one of the jurisdictional questions, that being the so-called physicals area. And that is being addressed in a model act, which we hope to have prepared for NASAA's fall meeting in Reno, Nev., this year. We will be discussing that in Atlanta in 2 weeks, the first draft, and, hopefully, it will grant broad jurisdiction over investments in metals that are sold but never intended for delivery. This has been a hallmark of the area.

As far as suggestions, I think we might need in the future, I think the ambiguities still have to be eliminated. Ambiguities in the leverage area and the off-exchange arena basically exist because some special interest groups have had some motives. They are outside the scope of traditional instruments. They are quite confusing and I think those people thrive, or that industry thrives, in that area of confusion.

We also must be assured that if we are to have shared jurisdiction that the States do have some shared jurisdiction.

There are some problems under 12(e) that are quite technical, I believe. There are some problems that remain whether it is truly open season.

I believe, and I believe the association agrees, that a system of concurrent jurisdiction, as it exists in the securities field, the SEC and the States, is really the route to go. For one organization to divest itself of jurisdiction in favor of another will not succeed as well, we believe, as concurrent jurisdiction in this particular area, the area of off-exchange fraud.

I think it is important also to note that this is not limited to CFTC involvement. If there are securities at the State level there may well be securities at the Federal level that may call for involvement of other agencies.

There is really no need for preemption in the off-exchange field. The arguments that would apply to the exchange traded instruments simply do not apply in the off-exchange area. We believe that that argument has been used as a sword by criminal elements, as opposed to the shield that was designed for the legitimate industry in interstate commerce.

Finally, I think it is extremely important to note in the off-exchange field that providing all the enforcement remedies in the world will not aid much if there are not people to enforce them. At the time when all the metals companies were opening and proliferating in southern California, the CFTC was able to station but one attorney on the west coast for the entire western region of the United States.

In addition, the Fort Lauderdale area has long been referred to in enforcement circles as the "Maggot Mile," for the metals dealers that have proliferated down there. And, yet, again, the CFTC enforcement division cannot afford to have anyone closer than 900 miles north, here in Washington. There is no physical presence in the Florida area. And, obviously, we would need people in the State area.

I suppose I should turn to Mr. Thomte's comments about commodity pools.

I will start by saying that I am by no means expert in the commodity pool area. We have others in NASAA who I believe do have significant expertise in the area, and I was able to prepare a report.

Let me precede this by saying that NASAA is merely an organization, no stronger than NAFTA. It is merely an organization composed of States. So there is no NASAA law. What NASAA adopted was a guideline available for the States to adopt if they so chose. To my knowledge, no State has so adopted the guidelines for commodity pools.

It is generally felt at the State level that in the capital formation stage of commodity pools, just like the capital formation stage of mutual funds, that regulation of commodity pools is not preempted. Pools are still registering at the State level and the guidelines were adopted, and I think after NAFTA had significant input in their promulgation. As I cited in the testimony, two State cases, one in the Kansas Supreme Court and the Oregon Appellate Court, holding that States were not preempted from applying securities laws to commodity pools in the capital formation stage.

It is important to note that neither case dealt with a registered commodity pool operator. To my knowledge, no State has brought an enforcement action against a registered commodity pool operator. No civil action has been brought under a State's securities laws that I know of against a registered commodity pool operator. The only exception to that statement would be, I believe that the State of Iowa brought an administrative action against Morgan J. Daly Corp. and David Delbridge. And it is important to note that Mr. Delbridge is now a convicted felon and is serving time in Federal prison for his commodity pool fraud.

We have been regulating them, at least the merit States have been. I am not from a merit regulating State, but they have been regulated. I think we can provide a more thorough response for the record, if the same is desired. But that is, basically, my statement.

Senator LUGAR. Thank you very much, Mr. Feigin.

The chairman of our committee has asked that I make a part of the record, and I will, of course, do so, an excerpt from the Senate Report on Futures Trading Act of 1982, which states this committee's position with respect to State regulation of commodity pools. The excerpt is, essentially, the one that is cited by previous witnesses from Senate Report No. 97-384, 97th Congress, Second Session, May 6, 1982, pp. 80-81.

To review that again, Chairman Helms offered another amendment relating to commodity pools. The amendment would add a proviso to new subsection 2 to be added by the bill to section 4(m) of the act. The amendment would provide that the provisions of this act shall preclude the qualification or substantive regulation of commodity pools under the various laws of the several States dealing with qualification or regulation of securities otherwise in those States.

Chairman Helms explained the amendment would clarify existing law by explicitly stating:

> The Commodity Exchange Act preempts all substantive State regulation of commodity pools under the various laws of those States. Commodity pools are regulated by both the CFTC and the SEC. Additional regulation by the States is neither needed nor desirable.

He also stated the Commission believes that existing law is clear and the amendment is not needed.

There is an additional part of the report.

[Excerpt from S. Rept. No. 97-384, 97th Congress, 2d session (May 6, 1982), pp. 80-81]

Chairman Helms offered another amendment relating to commodity pools. The amendment would add a proviso to new subsection (2) to be added by the bill to section 4m of the Act. The amendment would provide that "the provisions of this Act preclude the qualification or substantive regulation of commodity pools under the various laws of the several States dealing with the qualification or regulation of securities or otherwise in those States." Chairman Helms explained that the amendment would clarify existing law by explicitly stating that the Commodity Exchange Act preempts all substantive State regulation of commodity pools under the various laws of those States. If a commodity pool is regulated by both the CFTC and the SEC, additional regulation by the State is neither needed nor desirable. He also stated that the Commission believes that existing law is clear and the amendment is not needed.

After discussion, the Committee decided not to adopt the amendment since the law is clear and the amendment is, therefore, not needed. However, the Committee reiterates that Federal jurisdiction under the Commodity Exchange Act is exclusive vis-a-vis the several States, and that the several States are specifically preempted from the substantive regulation or qualification of commodity pools and commodity pool operators. In 1974 and again in 1978, the Congress expressed its intent that the Commission have exclusive jurisdiction over the substantive aspects of future trading and that unnecessary and duplicative regulation of the commodities industry be avoided. Notwithstanding this clear expression of congressional intent, however, many State securities administrators insisted or attempted to insist on State qualification of commodity pools under the blue sky laws of their various jurisdictions. In addition, many State regulators have imposed or attempted to impose substantive regulation on commodity pools and commodity pool operators that conflicts with Commission regulatory policy or imposes requirements which the Commission has specifically considered and rejected. Lastly, many State securities administrators now contemplate regulating the timing and method of compensation paid to the commodity pool operator.

The practical effect of this State regulation is to increase the cost to the investing public without any appreciable corresponding benefit. Since all commodity pools are subject to Commission regulation and since certain activities of commodity pools are also subject to both Commission and Securities and Exchange Commission regulation, State regulation of the same activity is clearly duplicative. The Committee notes that it was given the opportunity to restrict the exclusive jurisdiction provision of the Act with respect to State jurisdiction over commodity pools, commodity pool operators, and others during the course of the preparation of the bill and specifically chose not to do so. In light of the foregoing, it should be clear that the several States are specifically preempted from the substantive regulation or qualification of commodity pools and commodity pool operators. Nothing in the Committee's view on this subject, however, limits the powers of the several States under section 6d and proposed section 12(e) of the Commodity Exchange Act.

The Committee further notes that its amendment adding a new subsection (2) to section 4m of the Commodity Exchange Act is intended to clarify the extent to which the 1933 and 1934 Federal securities laws apply to the issuance of securities by commodity pools. Prior to this amendment, there was some confusion as to whether the CFTC's exclusive jurisdiction over accounts, agreements, and transactions involving futures contracts vested it with sole responsibility for the protection of persons who participate in the futures markets through a pool. The amendment is intended to make clear that the rights and remedies of the Securties Act of 1933 and the Securities Exchange Act of 1934 will be available to persons who are offered or who purchase securities issued by a commodity pool.

However, the amendment is not intended to impair the CFTC's exclusive jurisdiction over the operations of a commodity pool in connection with its trading activities. Specifically, the Committee intends that the CFTC will continue to have exclusive jurisdiction to regulate such matters as the trading conducted by commodity pools and the business operations of commodity pools, including the fees charged by the futures commission merchants, commodity trading advisors, and commodity pool operators.

The new amendment does not imply that the Investment Company Act of 1940 and the Investment Advisors Act of 1940 are applicable to the activities of commodity pools, commodity pool operators, and commodity trading advisors when such entities or persons purchase commodity futures contracts (or options thereon) based on securities or give advice as to the purchase and sale of futures contracts (or options thereof) based on securities.

Senator LUGAR. Is your testimony that notwithstanding all of this legislative record, and the intent of the chairman's motion, that there is an area here, you I think narrowed it to capital formation period, which clearly would be within the jurisdiction of State regulators?

Mr. FEIGIN. I believe that is the position that is shared by most of the State regulators that I am aware of, and certainly by the persons who participated in the formation of the guidelines, who exhibited more expertise in the area than I.

Senator LUGAR. Chairman Helms has raised the question and I would simply ask it: In light of this clear expression of legislative intent, why do many of the States persist in trying to regulate the activities of commodity pools, commodity pool operators, that apparently are already regulated by CFTC and the SEC?

Mr. FEIGIN. First, I would say that I believe that the States, in large part, 36 States, have merit statutes which try and assure that investors are offered securities that are fair, just and equitable in their presentation, and that the areas that are generally being dealt with, although I am reaching the limit of my breadth of knowledge in the area, generally deal with compensation to promoters of the various pools. These are clearly securities. The question is whether they are preempted securities. I think, based on some of the abuses we have seen, or the high compensation that is probably exhibited in many of the pools, it is the feeling of those States which review them with some expertise until we are really preempted—until we are really preempted by law, or told to get out of the area, we will not.

Senator LUGAR. You have indicated, and I do not want to press the issue, that we are, indeed, pressing you toward the limits of your competence in this area, would it be possible for you to consult with others in the association. I think you can gather the gist of the question that is being raised, and arguments in this hearing, and provide us as thoughtful and complete a statement, based upon the research you have so that the record will be complete? People will, in due course, read the record of this oversight hearing, and they will want to be guided by the very best argumentation that was available.

I appreciate your attempting to respond, and I think you responded well. But I am just inviting you to supplement that, if you would.

Mr. FEIGIN. Certainly.

Senator LUGAR. With additional argumentations, so that point of view will be known.

Mr. FEIGIN. We certainly will.

[The following letter was subsequently received by the subcommittee:]

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.,
April 30, 1984.

Mr. TERRANCE J. WEAR,
Assistant Counsel, Committee on Agriculture, Nutrition and Forestry,
Washington, D.C.

DEAR MR. WEAR: This letter is submitted on behalf of the Commodities Committee of the North American Securities Administrators Association, Inc. ("NASAA"), in response to the question asked of Mr. Philip A. Feigin, Colorado Assistant Securities

Commissioner, at hearings of the Senate Subcommittee on Agricultural Research and General Legislation on March 15, 1984. The question asked was:

"Mr. Feigin, the legislative history of the Commodity Exchange Act, and specifically the Futures Trading Act of 1982, clearly says that the States are preempted from the substantive regulation of commodity pools and commodity pool operators. The Senate report to the 1982 Act stated that this course of action was taken to avoid the burdensome and duplicative regulation of entities that are already regulated by the CFTC and SEC.

"In light of this clear expression of legislative intent, why do many of the States persist in trying to regulate the activities of those commodity pools and commodity pool operators that are already regulated by the CFTC and SEC?"

Because NASAA is a voluntary service organization of state securities administrators, it is not by this response intended to represent the views of each individual state that is a NASAA member. The Commodities Committee of NASAA submits the following response.

While the language included in the Senate Committee Report for the Futures Trading Act of 1982 asserted an intent to preempt state jurisdiction to regulate commodity pools, the language of the Commodity Exchange Act ("CEA") was not amended. An examination of the statute itself indicates that by its terms the CEA does not preempt state jurisdiction over commodity pools.

The creation of a commodity pool involves traditional capital formation by means of a passive investment that has traditionally been within the jurisdiction of state securities administrators. Trading in commodities by such a pool may be only one of the investment activities of the entity.

State commodity pool guidelines were developed by states coincidentally with the development of the commodity pool industry to provide guidance on the application of state securities registration statutes to this type of security.

The continuing doubt about whether the CEA may also have preempted state commodity pool regulation is mainfested in the fact that to our knowledge no private law firms have been willing to write opinions for reliance by their clients that state jurisdiction was preempted. Indeed, all large syndicators continue to apply for state registration of their commodity pool programs. Honest disagreement exists about the jurisdiction of states regarding pool programs, and administrators continue to process registration applications for pools.

If we may be of further assistance in any securities matter, please do not hesitate to call upon us.

Very truly yours,

LEE POLSON,
Vice Chairman, NASAA Commodities Committee,
Deputy Commissioner, Texas Securities Board.

Senator LUGAR. Now, the 1982 amendments significantly broadened the role of States through the so-called open season provision in the regulation of off-exchange activity. You have some qualms about how well that works, but has, in general that new authority proven useful to States' enforcement activity? Can you make a more comprehensive comment about that?

Mr. FEIGIN. Section 12(e) allows the application of any State law to off-exchange instruments and persons who are not or have not subjected themselves to CFTC registration.

The problem there, of course, is that we are allowed to assert any jurisdiction that we have. Do we have that jurisdiction?

Recognizing that, we set out in California by assisting California in its efforts to try and bring cases to court, to get decisions holding that these items are securities. There are a couple of administrative and civil decisions from the 1974 era, just before the Commodity Exchange Act, that started to hold that some instruments were securities. We are relying on them, and some imaginative reasoning to attempt to hold these things to be investment contracts.

Some States have other definitions that are useful, Arizona being one.

I think the record is clear that we are attempting very aggressively to apply our laws and our resources in the wake of 12(e) to fight this fraud. New York has the prosecution going against International Gold Bullion Exchange.

It was Arizona's effort that led to the bringing of the case against Smythe-Wheatley, Ltd.

California has issued some 20 odd subpenas against metals companies in southern California. Six of them have simply folded up and gone away, probably to start up elsewhere.

We are hopeful that 12(e) will provide many of the answers, although we believe there still are some questions. So there is a time lag, but we are taking up the challenge, I think successfully.

Senator LUGAR. States are now permitted to enforce antifraud provisions of the Commodity Exchange Act in State courts. Is this authority being utilized by State securities administrators?

Mr. FEIGIN. To my knowledge, it has not yet been used. There is an underlying problem with that provision of section 6(d), and that is that, as before, although several 6(d) actions were brought, they were basically instigated by the Commission under the 1978 versions of the act. It was not a particularly successful, well received remedy at the State level for a variety of reasons, one of them being that during that period, States could not obtain information from CFTC, as previously alluded to, the lack of subpena power beyond our borders, and we could not get information from the CFTC. That was extremely frustrating.

There was a general period of resentment: Why should I enforce their laws if they are going to preempt me? There was also the problem of going into Federal court, a strange venue for United States prosecutors.

The change in 6(d) to being able to go into State court may be of little substance because the defendant and/or the CFTC can immediately remove the matter to Federal court. And, for some reason, many of the people who end up being defendants in these cases would rather be in Federal court than State. So it may be an illusory remedy. However, it may be utilized because of section 6(c), which provides for a restraining order, an ex parte restraining order, that would prevent dissipation of assets and preservation of records, a real problem in these boilerroom activities. That type of order may be obtainable from a State court judge ex parte. If they remove it later, that is fine, but there is a freeze that is in place right now. So, in that narrow sense, if a State court judge can nationally freeze assets ex parte, that might be a "little jewel" that we will use quite effectively.

Senator LUGAR. As a followup, the 1982 amendments also mandated CFTC to share pertinent information with States for the purpose of prosecuting unlawful conduct.

Have you found CFTC to be cooperative in this respect?

Mr. FEIGIN. Absolutely. If I have not stated it clearly enough, the cooperation that we have felt between the CFTC and the States has been at the highest level imaginable. Information is being shared constantly as well as expertise and staff time. We could not ask for more so far as cooperation at the enforcement level with CFTC.

Senator LUGAR. Several witnesses have expressed concern about the presence of unregulated off-exchange trading activity. The CFTC does not have the resources to control all of this activity. Do you feel that States will be able to take over more responsibilities in this area, and under what circumstances?

Mr. FEIGIN. Well, certainly, if these instruments are found to be securities under some very good State law, if an *SEC* v. *Howey* comes along that clearly says these are securities, our efforts will, obviously, be strengthened.

If that does not occur, or even if it does, we will have to consider the model act to fill that jurisdictional gap.

It is important to note that the States have always been, as the chairman stated before, the cop on the beat. We are used to patrolling in the exotic securities area. We can laugh at them now, but they are quite serious if it is your $5,000 that is lost. The earthworms, every other exotic instrument that you can think of. We are the ones who deal with those on a consistent basis, and I believe we can at least provide an important element in the battle against that fraud.

Senator LUGAR. Mr. Feigin, I do appreciate your testimony. I would take this occasion to thank all witnesses who have come today and shared in a long and extensive hearing, but one which we believe will be useful as a matter of record. Without further comment, the hearing is adjourned, and we thank everybody for participating.

[Whereupon, at 4:40 p.m., the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

STATEMENT OF HON. WALTER D. HUDDLESTON, A U.S. SENATOR FROM KENTUCKY

Mr. Chairman, I commend you for scheduling this oversight hearing on matters relating to the Commodity Futures Trading Commission.

This year will, of course, mark the 10th anniversary of the Commodity Futures Trading Commission Act, which established an independent regulatory agency to regulate futures trading. The 1974 Act made extensive changes in the Commodity Exchange Act, brought under Federal regulation all agricultural and other commodities, goods, and services traded on exchanges, and otherwise strengthened the regulation of the commodity futures industry.

Since 1974, the Commission has undergone two congressional reauthorizations. The most recent one was, of course, in 1982, and I think it most appropriate that the Agriculture Committee—which is, of course, the committee of jurisdiction in the Senate with respect to futures trading—review the work of the Commission in implementing the 1982 Act.

I think I can speak for all members of this committee in stating that a strong and independent regulatory commission is essential to the effective operation of the futures industry. While the Commission must work closely with other Federal agencies and the States in performing its responsibilities, it must be zealous of its legislative jurisdiction and carry out the intent of Congress.

I look forward to the testimony of today's witnesses.

STATEMENT OF HON. HOWELL HEFLIN, A U.S. SENATOR FROM ALABAMA

I would like to mention my concerns with the CFTC/SEC jurisdictional guidelines which are now being contested in Federal courts, I believe that the issue of the guidelines will not be raised at this hearing since it is the subject of litigation. However, I would like to note for the record that it is the responsibility of this committee to oversee the actions of the agency involved in administering the Commodity Futures Trading Act, which includes overseeing jurisdictional disputes between the CFTC and other agencies. I am very concerned with regards to the possibility of the CFTC relinquishing jurisdiction which I believe Congress intended it to have and I urge the Commission to be zealous in its jurisdiction in working with other Federal agencies and the States. Furthermore, I want to reiterate the importance of the Commission consulting with this committee in all of these matters. I believe it is important that I express my concerns even more though this issue will probably not be discussed today at that hearing.

STATEMENT OF HON. SUSAN M. PHILLIPS, CHAIRMAN
COMMODITY FUTURES TRADING COMMISSION

Mr. Chairman and Members of the Committee:

Since the Congress enacted, and the President signed, the Futures Trading Act of 1982, that legislation has proven itself to be an important force in improving commodity futures regulation without stifling industry growth. For example, as a result of the jurisdictional accord codified in the 1982 amendments, a variety of innovative futures and options contracts are being traded for the first time. New classes of industry professionals are engaged in the sale of futures and options, and rules are in place for regulated leverage transactions and domestic agricultural options.

In addition to enlarging the numbers of participants and products, the new legislation was expansive in the protections it provides for the customer and the markets. The National Futures Association (NFA) and the states were called upon to play an important and expanding role in regulation and enforcement. Private rights of action were made explicit, more clearly delimiting the conditions under which private litigants may proceed under the Act and potentially alleviating some of the burden on the Commission's reparations program. In addition, statutory disqualifications from registration were established to implement the Act which makes it clear that certain conduct renders an applicant unfit for registration as a commodity professional, thereby enhancing customer protection and improving the Commission's effectiveness in removing those who are unfit from the industry.

In sum, the legislative evolution of the Commodity Exchange Act, as reflected particularly in the 1982 amendments to the Act, has enhanced the role of industry self-regulation and the Commission's ability to fulfill its oversight responsibilities. I would like to detail for you the progress of the Commission in implementing the programs authorized or mandated by the Futures Trading Act of 1982.

Domestic Agricultural Options

The 1982 amendments to the Commodity Exchange Act lifted the ban on the trading of domestic agricultural options and authorized such transactions pursuant to a pilot program. In order to solicit the views of the public, particularly farmers and agribusinessmen, on such a program, the CFTC scheduled a series of nine informational meetings around the country in March 1983. In June of the same year, the Commission established the Agricultural Options Advisory Committee composed of representatives from general farm organizations, specific commodity organizations, commercial users, agricultural lenders, USDA and the commodities industry. The Committee's task was to provide advice to the staff and the Commission on the desirability and feasibility of such a program and on the policy and practical considerations inherent in various regulatory alternatives. On October 4, 1983, the Commission published for comment proposed rules governing a pilot program for the trading of options on domestic agricultural futures contracts. After evaluating the comments, on January 16, 1984, the Commission adopted final rules which have been transmitted to the Congress, along with an interim evaluation of the Commission's ongoing option pilot program in commodities which were not subject to the ban. The thirty-day Congressional review period expired on March 14, 1984, and the Commission has begun to accept designation applications from the exchanges. It is our hope that agricultural options will be trading this fall.

Registration of Commodity Professionals

On August 3, 1983, the Commission adopted rules to implement the Act's provisions concerning four new categories of persons who must be registered with the Commission: introducing brokers and the associated persons of introducing brokers, commodity trading advisors and commodity pool operators. The new rules establish registration requirements and procedures for these new categories of registrants; prescribe minimum financial, reporting, and recordkeeping requirements for introducing brokers; create certain exemptions from registration; limit the ability of associated persons to be associated simultaneously with different sponsors and set forth a framework for participation in the Commission's option pilot program by introducing brokers. To date approximately 500 firms, with more than 4,000 associated persons have taken steps to become registered as introducing brokers. The NFA has undertaken to register introducing brokers and their associated persons as its first area of registrant responsibility delegated by the CFTC. It is anticipated that the responsibility for registering other classes of registrants will be delegated to NFA during 1984.

On May 20, 1983, the Commission published notice of the effectiveness of new Section 4k(5) of the Act, which imposes liabilities on registrants who hire or otherwise employ persons as associated persons if the registrant knew or should have known of facts regarding the associated person which constitute statutory disqualifications from registration. This notice also informed registrants of the procedure for informing the Commission of such facts, in order to avoid the liability imposed by Section 4k(5).

The reauthorization legislation amended the registration provisions of the Act to provide the Commission with greater flexibility in the administration of its registration program. The Congress authorized the Commission to issue temporary licenses to apparently qualified applicants for registration, thereby permitting them to begin work while FBI and SEC fitness checks are being conducted. The Congress also established the previously mentioned system of "statutory disqualifications" which enumerates the most important bases for finding applicants or registrants unfit for registration. On October 25, 1983, the Commission published for comment proposed rules which will implement these new provisions of the Act. The Commission adopted final rules on February 22, 1984, and is working with the NFA to implement expeditiously a program for temporary licensing.

Role of the States under the Commodity Exchange Act

The 1982 amendments significantly broadened the role of the States through the "open-season" provision which permits the application of any and all state laws to off-exchange transactions. Further, the States are now permitted under Section 6d to enforce the antifraud provisions of the Act and Commission regulations in state courts as well as in federal district courts. In addition, the statute authorizes the Commission to provide registration information to the states and generally permits the free flow of information between the Commission and the states to aid the states in preparing their own enforcement cases.

The Commission has worked diligently over the past year to encourage and assist the states in taking an active role in the protection of their citizens. We have approached this undertaking on several fronts -- information sharing, training, cooperative enforcement actions, and providing CFTC staff support for the drafting of model state legislation. I would like to elaborate on these four approaches.

First, on May 17, 1983, the Commission amended its rules to delegate to certain Commission staff the authority to transmit to any department of any state or political subdivision thereof the registration and other information permitted to be disclosed by the 1982 amendments. The Commission has been regularly utilizing this authority to share information to assist the states in their investigations and proceedings.

Second, a two-day seminar was conducted last fall by CFTC enforcement staff in which representatives from 20 states participated. Investigative and trial techniques for prosecuting commodity fraud cases were discussed. A similar regional seminar was held early this year in Los Angeles where forty-three state representatives participated in addition to seven representatives from other federal agencies and Quebec, Canada. I am pleased to report that NFA also participated in and supported these seminars.

Third, we have informed every state attorney general and securities administrator that we stand ready to assist the states in developing and prosecuting commodity-related fraud cases. This effort has resulted in a number of cooperative enforcement actions since January 1, 1983. The Commission has also created a State Liaison Unit within the Division of Enforcement to assist the states as they expand their efforts in the prosecution of commodity-related fraud. In this regard, we have also begun work on compiling a Violators Bulletin for use by the states and other federal enforcement agencies.

Fourth, Commission representatives, staff from the NFA and state representatives from the North American Securities Administrators Association (NASAA) recently met in Chicago to discuss developing a coherent regulatory and enforcement plan to utilize and integrate appropriate state, federal and self-regulatory resources. The particular focus of the discussions was a regulatory and enforcement strategy to deal with the offer and sale of off-exchange commodity-related contracts that are not regulated by the Commission. As a result of this meeting a working group of NFA, CFTC and state representatives has been established and has met to draft model uniform state legislation to give states additional tools to deal with off-exchange commodity-related transactions.

We have made enormous strides the past year toward developing strong and effective working relationships with the states and NASAA, which will result in increased and improved public protection. Evidence of this cooperation can be seen in the recent joint action of the CFTC and the state of Arizona against a company fraudulently operating as an unauthorized leverage merchant. (CFTC and the State of Arizona vs. Smythe Wheatley Ltd., et. al.)

Leverage

On January 16, 1984, the Commission adopted interim final rules for the regulation of certain leverage transactions. These rules, which will generally become effective on April 13, 1984, establish a comprehensive regulatory scheme to govern the offer and sale to the public of certain leverage contracts. In addition to defining a leverage contract, the interim rules include provisions concerning the registration of firms and salespersons engaged in marketing leverage transactions, the registration of commodities which are the subject of leverage transactions, a $2.5 million minimum adjusted net capital requirement for leverage dealers, a requirement for the segregation of customers' funds, and certain recordkeeping and reporting requirements. The rules also require that detailed disclosures be made to leverage customers and potential customers and that first-time leverage customers be provided with a three-day right to rescind their leverage contracts.

At this time, the Commission intends to continue in effect for a time its regulatory moratoria on the offer or sale of new products and on the entry of new firms into the leverage business. In this connection, leverage firms seeking to be registered under the interim rules will be required to demonstrate that they were in the leverage business prior to the imposition of the moratoria.

As this Subcommittee is aware, the regulation of leverage firms is a new and very different undertaking for this Commission. In addition to the unique nature of the leverage business, the lack of self-regulatory organizations interposed between the CFTC and the firms requires us to assume the uncustomary role of primary and sole regulator. The staff has been directed to report back to the Commission in six to nine months on the effects and effectiveness of the interim leverage rules, the resource implications for the Commission of lifting the moratoria, as well as the feasibility and implications of implementing or utilizing some form of self-regulatory oversight for the leverage industry.

Studies

The Commission has also committed substantial resources to four congressionally mandated studies. The Special Study of Futures and Related Markets is being organized by the

Federal Reserve Board, with active participation by the CFTC and the SEC. The focus is on futures and options on financial instruments, notably stock-related products, but attention also is being paid to the more traditional futures markets as a basis for comparison and illustration.

The agencies, based upon the specific guidance from the Congress contained in Section 23 of the Commodity Exchange Act, have developed a comprehensive study outline and have divided the drafting assignments. The SEC and CFTC have parallel responsibilities for providing an historical perspective on the economic genesis of the respective markets and how they have been used. Similarly, the evolution of the current regulatory schemes under which the stock and futures markets operate will be addressed. We also will examine potential problems or abuses in each market and the regulatory responses. The Federal Reserve Board, in addition to coordinating the study, has assumed the initial responsibility of addressing macro economic issues such as the effects of these markets on capital formation and monetary policy.

In order to develop data on the nature of market participants, their financial commitments and resources and their investment experience, the three agencies have contracted for a telephone survey of public customers in several different markets. Commercial users will also be interviewed. In the case of futures, a sample of customers will be drawn from the information collected by a special call made on the FCMs and exchange clearing members on November 11, 1983. While largely descriptive, the data collected as a result of the survey can provide important insights into the use of the markets and whether the present regulatory structure is appropriate for the types and numbers of market users who are identified. The three agencies intend to submit a single document to the Congress at the close of fiscal year 1984.

The Commission is also conducting an examination of the extent and implications of trading in the futures markets by persons possessing material, non-public information. The study will analyze the body of law concerning insider trading in securities and discuss the major issues which have arisen in the application of insider trading prohibitions, such as the concepts of materiality, misappropriation and fiduciary duty as they might apply to trading in commodity futures contracts. The study will not, however, necessarily be guided or limited by the securities experience. Rather, we will look at the extent to which securities law concepts and experience may be applicable to futures trading. An important part of the study will focus on the kinds of information available in the futures markets which might be considered non-public and material, and who reasonably could be expected to possess such information.

We will examine possible types of behavior which could be prohibited and will look at relevant incidents which have prompted significant Congressional interest in the past. We will attempt to determine whether, and if so why, certain commercial and other firms currently prohibit officers and employees from trading in futures markets. To the extent that futures trading by officers and employees is permitted, we will ascertain the conditions under which employees are permitted to trade and the extent to which employees are participating in the same or related markets as their firms. As part of this inquiry we are analyzing trading based on large trader reports filed with the Commission. Finally, the study will assess the possible effects of trading while in possession of such information and present a legal analysis of the existing statutory and regulatory authority to deal with any identified potential abuses.

This Commission is also conducting a study to determine the adequacy of Commission authority to prevent unwarranted price pressures as a result of the trading activities of the largest hedgers in the livestock markets. Our report to the Congress will be in two parts, the first of which is contained in the CFTC's 1983 Annual Report.

This study assesses how large hedgers have used their exemptions from exchange speculative position limits and whether any market disruptions can be attributed to large hedgers' trading activities. We are examining the absolute and relative sizes of the large hedger positions and analyzing the specific trading practices of twelve of the largest hedgers in the cattle, hog and porkbelly futures through on-site interviews. The interview process has begun but will not be completed for several months. Particular attention will be paid to large hedge positions in expiring futures and the involvement of large hedgers in troubled markets. The final report will be published in the 1984 CFTC Annual Report.

Finally, the Commission will report to Congress by January 1, 1986, on the regulatory experience of the National Futures Association.

Registered Futures Associations

New Section 17(p) of the Act required the National Futures Association to submit for Commission approval by April 11, 1983, rules that would require the Association to establish training standards and proficiency testing requirements, financial requirements and sales practice standards. To the extent the NFA had not obtained Commission approval of all such provisions covered by Section 17(p) prior to its enactment, the Association submitted the remaining rule changes needed to comply with Section 17(p), and the Commission approved those various submissions in April 1983. The National Futures Association is continuing to develop comprehensive programs to implement the rules required by Section 17(p), as mandated by new Section 17(q), which requires such programs to be in place by September 30, 1985.

On June 7, 1983, as authorized by Section 17(m), the Commission adopted a rule requiring all futures commission merchants required to be registered with the Commission also to become members of a registered futures association. On August 3, 1983, the Commission approved NFA rules under which the Association would administer registration functions on behalf of the Commission and authorized the National Futures Association to grant registration to applicants for registration as introducing brokers or associated persons of introducing brokers. The NFA has reported to the Commission that it anticipates assuming other categories of CFTC registration in early 1984, with completion of the transfer of registration responsibility by the end of 1984, or early 1985.

The Commission also approved rules governing disqualification from NFA membership which parallel the statutory disqualifications from Commission registration. In addition, the Commission has approved rules under which the National Futures Association may establish proficiency standards -- including training, experience and proficiency testing of applicants -- for Commission registration through the National Futures Association. Subsequently, the Association submitted a requirement that persons applying for registration as associated persons of introducing brokers take and pass the National Commodity Futures Examination as a condition of registration.

Although the Commission has approved NFA rules governing conditional registration as well as denial, suspension, restriction or revocation of registration, the Commission has withheld delegating authority to act under these rules until Commission staff has developed a procedure for Commission review of these kinds of registration decisions by the futures association.

On May 17, 1983, the Commission revised Rule 170.8, regarding futures association arbitration, to reflect the statutory amendments which permit claims over $15,000, re-define the term customer and eliminate the restrictions on compulsory payment. Rule 170.8 also has been revised to include the requirement of new Section 17(b)(10) of the Act that a futures association must provide an "expeditious" procedure for settlement of customers' claims.

The Commission has appointed a staff liaison to the NFA who reports on a monthly basis to the Commission on NFA's progress in implementing its self-regulatory program. In addition, the staff and officials of NFA have reported to the Commission on its progress and plans in open sessions of the Commission in April and October of 1983 and February, 1984. Most notably, NFA has begun to implement auditing, registration, arbitration and testing programs.

Reparations

Pursuant to 1982 amendments to Section 14(b) of the Act which vested the CFTC with broad authority to refashion its reparations procedures, the Commission on February 14, 1984, adopted final reparations rules designed to make its reparations process operate more efficiently and expeditiously. The new rules, effective April 23, 1984, feature three distinct decisionmaking procedures, the voluntary decisional procedure, the summary decisional procedure, and the formal decisional procedure, each of which varies from one another in terms of probable length of time necessary to reach a decision.

The voluntary decisional procedure, the most expeditious of the three, is available where all parties agree to submit their claims and counterclaims in documentary form for a final decision by a CFTC official which is not appealable to the Commission of a court. The summary decisional procedure is available where the amount in controversy does not exceed $10,000, and affords parties a limited opportunity to present oral testimony, and a decision by a CFTC official that may be appealed to the Commission and, thereafter, to a court. The formal decisional procedure is available where the amount in controversy exceeds $10,000, and allows parties the opportunity for an oral hearing and a decision by an Administrative Law Judge, appealable to the CFTC and a court.

The new rules also contain significant modifications to the Commission's former reparation rules relating to time allowed for responding to specific motions, motions for extension of time, service, filing of documents, withdrawal of representation by counsel, the prohibition against ex parte communications, voluntary dismissal, defaults, parallel proceedings, and the Commission's appellate rules.

Service Fees

In accordance with Congress' acknowledgment in amended Section 26 of the Futures Trading Act of 1982 of the Commission's authority to promulgate a schedule of fees for its activities and functions, the Commission, effective August 23, 1983, adopted a nonrefundable $10,000 fee for futures and option contract market designation applications. The Commission stated that it would review the fee at the beginning of fiscal year 1985 and each subsequent year to ensure that it continues to reflect the actual costs of the designation process. In addition, exchanges were given an opportunity to withdraw pending applications. As a result of this action 29 of the 57 designation applications then before the Commission were withdrawn.

On August 1, 1983, the Commission adopted revisions to its existing fee schedule to reflect the actual costs to the Commission of processing materials for registration and other Commission programs. The revised registration fees are either the same as, or slightly higher than, the fees previously in effect. The Commission also revised its filing fees for reparations claims to reflect the relative costs of the three decisional procedures available under the revised reparations rules. Since the Commission delegated responsibility for registering introducing brokers to the National Futures Association, the Commission did not adopt registration fees for introducing brokers or their associated persons. Also, on October 11, 1983, the Commission adopted a revised schedule of fees for requests for copies of Commission records, Commission reports, and transcripts of Commission meetings. Commission staff currently is studying the feasibility of other fees for specific regulatory services provided by the Commission.

The Commission has recently published for comment proposed fees for audits of leverage transaction merchants and the registration of leverage commodities.

Streamlining of Rules

The Commission has made significant progress in streamlining a number of its other rules and regulations. On January 28, 1983, the Commission adopted emergency interim regulations to govern the submission of contract market rules, pursuant to the new Section 5a(12) rule review procedures mandated by the Futures Trading Act of 1982. Specifically, the Commission revised its regulations to define "terms and conditions in contracts of sale" which must be submitted to the Commission for approval, amended Rule 1.41 to set forth those types of rules which are exempt from submission pursuant to Section 5a(12) of the Act, delegated to the Division of Trading and Markets the authority to determine when submissions which do not relate to "terms and conditions" do not require Commission review, delegated to the Division the authority to remit submissions which do not meet the form and content requirements set forth in Commission regulations and made certain other conforming amendments. On October 24, 1983, the Commission adopted the final rules to put into effect Commission delegations and procedures pursuant to new Section 5a(12).

Speculative Limits

An amendment to §4a(5) of the Commodity Exchange Act gave the Commission authority to enforce exchange speculative limit rules in addition to any Federal speculative limit regulations. We intend primarily to use this authority to assist exchange rule-enforcement efforts involving non-members, but this authority also enables the Commission to act independently of the exchanges to ensure that all speculative limit rules are enforced. Each exchange that had any contract markets lacking federal or exchange speculative limits has submitted proposed rules setting speculative limits for approval by the Commission. Of the eight exchanges that were required to submit speculative limit proposals for their contract markets, four proposals have been implemented and we expect to complete Commission action on the proposals of the four remaining exchanges during the first half of 1984. We also plan to review the current Federal speculative limit regulations for grain and soybean futures after we have assessed the effectiveness of exchange speculative limit programs.

Confidentiality and Disclosure of Commission Information

On May 17, 1983, the Commission, in order to implement new Sections 8(e) and 8a(6), amended Part 140 of its rules to delegate to certain Commission officials the authority to disclose information under special circumstances to any department, agency or political subdivision of a state or foreign government, and to disclose information about disruptive or harmful market transactions to officials of registered futures associations or self-regulatory organizations. The Commission also added a new Rule 140.75, which delegates to the Division of Trading and Markets and certain Commission staff members the authority to transmit to any department of any state or political subdivision thereof the registration information required to be disclosed in new Section 8(g).

On May 25, 1983, the Commission proposed rules to implement Sections 8(a), 8(b), and 8(f) of the Act. These rules, adopted earlier this year, allow the Commission to withhold information contained in records of a pending investigation, to provide for notice prior to release of information pursuant to a subpoena or summons, and to delegate to certain Commission employees the authority to disclose information in connection with a receivership or bankruptcy proceeding.

Personnel Restrictions and Prohibitions: Code of Conduct

The Commission has revised the Code of Conduct for Commission members and employees and former members and employees to conform to amended Section 9(d), which broadened the exceptions to the prohibition against investment transactions in actual commodities and has modified the procedure for notification of excepted investment transactions. In addition, the Commission extended the prohibition of Rule 140.735-9 to bar the dissemination of non-public information by members and employees about margin accounts, margin contracts, leverage accounts, leverage contracts and their functional equivalents consistent with amendments to Section 9(e) of the Act. The Commission also deleted all references to repealed Section 2(a)(7)(B), which contained essentially the same one-year post government employment restriction now contained in 18 U.S.C. § 207(c).

Bush Task Force

The Vice President's Task Croup on Regulation of Financial Services is nearing completion of over fourteen months' effort in reviewing the federal regulatory presence in the areas of finance, banking, securities and futures. The Group's report to the President is currently being finalized.

As widely reported, a number of items were proposed, but rejected, which would have affected the Commission and its operations -- among them merging the Commission with the SEC, having some of the same Commissioners serve on both Commissions, housing both Commissions together, mandating regulatory "parity" by statute, and establishing a federal authority to set margins for all financial futures and options.

As Chairman of the Commission, I participated fully in the deliberations of the Task Group. We consistently took the position that the Congress had recently reviewed the Commission and its enabling legislation and that no changes were necessary at this time. We also pointed out the ongoing discussions between this Commission and the Securities and Exchange Commission which focus on eliminating duplicative and burdensome regulatory requirements placed on those who participate in both types of markets.

This process of consultations will be continued. Additionally, the report will recommend a change in securities law which will be patterned in part after futures practices, specifically that SEC regulated options exchanges have the authority to set their own margins, subject to SEC oversight. There are no recommendations in the report, however, for changes to the Commodity Exchange Act.

Interpretation of the CFTC-SEC Accord

Recently the CFTC and the SEC published in the Federal Register an interpretive statement dealing with designation guidelines for futures contracts based on non-diversified indices of domestic equity issues. The guidelines are designed to facilitate review of applications for designation based on such indices and to enable potential applicants to structure their applications in a manner consistent with how the agencies believe the Accord should be interpreted. The agencies will review the guidelines by January 31, 1985 or ninety days after submission to Congress of the Special Study of the Futures and Related Markets. The guidelines are the subject of ongoing litigation by the Chicago Board of Trade. (Board of Trade of the City of Chicago vs. Commodity Futures Trading Commission and the Securities and Exchange Commission).

Contract Approval

Since January 11, 1983, the Commission has designated 23 new contracts for trading. There are presently 27 futures applications and 2 options contracts awaiting consideration. In just a few days, we expect to receive several applications under the agricultural options program. Coincidentally, we have just entered the period when the one year limitation on Commission action is becoming a relevant factor.

Although we have greatly reduced the time which elapses between initial filing of applications and Commission approval, we have become aware of significant changes in our handling of contract applications brought on by the one year limitation.

While the statutory limitation has had its intended effect of reducing the review time on individual contracts, another result has been to remove a substantial portion of the flexibility previously enjoyed by the Commission and the exchanges in prioritizing their applications. Otherwise deserving contract applications must wait their turn while limited Commission resources deal with applications having a more immediate deadline.

This change in the legislation has also had the unintended effect of rendering the relationships between Commission staff and the exchange more formal and less flexible in dealing with deficiencies in contract applications. While formerly many such problems could be dealt with through staff discussions, most such areas of concern must now become the subject of formal correspondence between the staffs of the Commission and the exchanges.

Conclusion

My Commission colleagues and I believe the staff of the CFTC has done nothing short of a remarkable job in implementing the changes required by the 1982 amendments which were undertaken in addition to the day-to-day functions of contract designations, rule approvals, registrations, auditing, litigation, surveillance, enforcement, and education activities. Thus, in the past year, the Commission has designated 23 new contracts, disposed of 990 reparations cases, conducted 6 contract market rule enforcement reviews, 7 self-regulatory organization audit and financial surveillance reviews, filed 74 enforcement cases, conducted 222 audits and registered 48,000 industry professionals. The staff continually proves itself to be dedicated, intelligent, and highly motivated.

On behalf of the Commission, I want to thank the Committee for the opportunity to provide you with this report on the Commission's activities.

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

Chairman Lugar; Distinguished Members of the Committee on Agriculture, Nutrition and Forestry; Ladies and Gentlemen.

I am Robert K. Wilmouth, President and Chief Executive Officer of National Futures Association. I am delighted to be before you again -- under far different circumstances, I might add, from when I last appeared before this Committee. That appearance was during the 1982 hearings on CFTC reauthorization, when the very existence of NFA was in serious doubt.

I can emphatically state that this is not the case today. NFA is very much alive and well -- alive and well, I must add, because of you.

In rebuffing the CFTC's transaction tax scheme two years ago and, instead, in supporting the NFA plan which the futures industry offered, you made NFA a reality.

It was your commitment in 1982 to the premise and promise of NFA that convinced me -- and other futures industry leaders -- that our industry had to deliver in spades -- and deliver fast. Frankly, the challenge excited me, so when Leo Melamed and others approached me and asked whether I would leave the presidency of the Chicago Board of Trade and take up trowel, brick and computer program to build the new NFA organization, I accepted enthusiastically.

Suffice it to say that I did have second thoughts along the way. Going from the presidency of the world's oldest and largest futures exchange to the presidency of the world's youngest and smallest -- and least solvent -- self-regulatory organization was a sobering experience -- particularly for a former banker.

But with the unqualified support of every sector of the futures industry, we have assembled a well-motivated, dedicated and highly capable staff. And as we approach the mid-term of the current CFTC reauthorization, I think you can be pleased with our results.

We also are approaching the mid-term of the review period which you set for NFA. As you will recall, this Committee was not content to accept the promises of the futures industry on blind faith. No indeed; you directed the CFTC to give you a report card on NFA covering the period from January 1, 1983 through September 30, 1985 -- to spur us on and, ultimately, to aid you in determining whether we fulfilled our part of the bargain.

At mid-term, I can report without reservation that NFA is very much on target in all areas. In short -- and to quote from your former House colleague Bill Wampler, who serves as an NFA public director -- "NFA is doing what Congress intended."

Some statistics may be helpful. First, our membership: All ten independently-operating U.S. futures exchanges are NFA members, as are -- as of February 29, and excluding multiple memberships -- 338 Futures Commission Merchants, 434 Commodity Pool Operators, 406 Commodity Trading Advisors, and 54 Introducing Brokers.

And speaking of membership, the CFTC has followed your mandate of 1978, reaffirmed in 1982, by requiring that each FCM must become and remain a member of at least one registered futures association.

The result is that, in conjunction with NFA rules, all futures industry professionals are now subject to self-regulatory oversight. With regard to NFA specifically, the many FCMs, CTAs, and CPOs who were not exchange members -- and some of whom operated at the twilight zone of regulation -- are now under NFA oversight and are subject to our customer protection rules and standards.

When we began the first of our regulatory operations some 16 months ago -- on October 1, 1982 -- our staff already consisted of 60 individuals. As more of our programs have become operational, we have grown to 160, with compliance and related registration staff comprising 74% of the total. We maintain offices both in Chicago and New York, and on any given day we have an average of more than 45 people engaged in field-audit and financial surveillance activities.

Compliance, first and foremost, is what NFA is all about. It encompasses a variety of activities -- financial surveillance, field examinations, and special investigations -- designed to prevent violation of NFA rules whenever possible and to initiate prompt corrective or disciplinary actions whenever necessary.

Firms and individuals subject to NFA compliance requirements must maintain complete, accurate, and up-to-date records; remain properly capitalized; segregate and account for customer funds; and adhere to ethical and honest business practices.

To enforce these rules, a total of 342 examinations were conducted by NFA auditors through February of this year. Additionally, in 40 instances our daily financial surveillance of the non-exchange firms handling customer funds found possible rule infractions and led to appropriate NFA action. And, in response to indications of potential serious rule violations -- stemming from audits, referrals, or public complaints -- NFA staff has conducted a total of 106 preliminary inquiries, which led to 13 full scale investigations.

And consistent with NFA's customer protection responsibilities, our compliance personnel routinely monitor sales literature and other solicitations involving or appearing to involve futures. Also screened are advertisements for employment in the futures industry, particularly for sales personnel.

In all instances, the objective is to assure that persons considering futures transactions receive adequate, accurate and straight-forward information on which to base their decisions.

When violations of our rules are found, NFA possesses both the authority and the determination to deal swiftly and appropriately. Already our Regional Business Conduct Committees have issued 13 formal complaints, as well as a number of warning letters.

And, when a situation arises where an immediate risk to customers or the industry requires an immediate remedy, NFA has the power to take appropriate Member Responsibility Actions on a summary basis.

For example, in emergency circumstances, a firm may be barred from soliciting or making any additional futures transactions, or its NFA membership and right to participate in futures markets may be suspended. To date we have taken 18 Member Responsibility Actions.

In the area of registrations, NFA already is playing a major role in the registration of Introducing Brokers. As of February 29, we had received over 900 IB applications. All of these applicants or applications have either been approved, notified of application deficiencies, withdrawn, referred for federal agency fitness checks, or referred to the CFTC for denial.

Yet another important accomplishment at mid-term has been the development and implementation of the NFA arbitration program. Designed to be an alternative to litigation or CFTC reparations, its purpose is to promote a fair, as well as generally faster and less expensive, means of resolving futures-related disputes between the trading public and our members.

The NFA arbitration system became operational on

March 31, 1983. Already we have received a total of 137 notices of intent to arbitrate, and 58 formal Demands for Arbitration have been made. Eleven claims have been settled prior to hearing. Nine cases have been resolved through hearing and award; and 18 others are ready for hearing. The average time from filing to resolution has been six months.

Besides speed, an important goal of our program is convenience. NFA attempts to schedule arbitration hearings as close as possible to both parties. To accomplish this, we already have a roster of 246 qualified arbitrators in 29 states.

* * *

I have focused in these brief remarks on some of the customer protection aspects of NFA at mid-term. Customer protection has always been the principal concern of this Committee and the specific reason why you have fostered the NFA concept. There is much more to tell at mid-term, however, as outlined in a detailed statement which we have prepared. I would be grateful if this statement could be made a part of the record of today's hearings.

* * *

At the risk of over-staying my welcome, however, I would like to make three additional points about NFA at mid-term.

First, with jurisdiction once again a topic of debate, I am pleased to report that substantial progress has been made in one jurisdictional area that has often required the attention of this Committee -- state jurisdiction. As a first step, last year we named a senior NFA staff member as Enforcement Liaison to all the 50 states through the North American Securities Administrators Association. And through the initiative of NFA, in cooperation with the CFTC, a number of very productive meetings have been held with state officials represented through the NASAA.

On January 12, representatives of NASAA and the CFTC, including Commissioner Fowler West, met with us in Chicago. An agreement was reached to form a working group to draft model state legislation to give the states the tools to better deal with off-exchange commodity-related investments. That process is now underway, and meetings of the working group have already been held. An initial draft of model state legislation is being circulated and will be reviewed at a meeting in Atlanta on March 28.

Second, throughout our start-up period, we have received the full and enthusiastic support of the CFTC. The Commission and its staff have cooperated with us at every turn; they have encouraged us in every way. There have been absolutely none of the petty jealousies that one might expect when a new kid arrives on the block for the announced purpose of taking over a bit of the turf.

The same must be said for the futures industry. Through direct participation on our governing Board, our Regional Business Conduct Committees, our arbitration panels, our advisory committees and task forces, literally hundreds of futures industry professionals -- from the exchanges, brokerage firms, the Futures Industry Association, and the National Association of Futures Trading Advisors -- have rolled up their sleeves to build a viable and effective NFA. The commitment of this industry to NFA has been no less than the commitment of this Committee.

* * *

When Leo Melamed -- then and now NFA's Chairman -- appeared before Congress in February of 1982, when the prospects for NFA seemed bleakest -- he said:

> We can do much . . . through self-discipline, at our own cost. We ask you to give us that chance. We ask you to give NFA the chance to

> take part in the self-regulatory process that the industry knows how to do, can do, is offering to do, and will do.

You gave us the chance. And thanks to your encouragement and wise judgments in 1982, the futures industry is stronger and better policed today. Our programs and systems for customer-protection are second to none.

I am proud of this -- proud of NFA, proud of our industry.

Thank you.

DETAILED STATEMENT OF
ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE SUBCOMMITTEE ON
AGRICULTURAL RESEARCH & GENERAL LEGISLATION
SENATE COMMITTEE ON AGRICULTURE,
NUTRITION & FORESTRY

MARCH 15, 1984

National Futures Association

NFA

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST • CHICAGO, IL • 60606 • (312) 781-1400

ROBERT K. WILMOUTH
PRESIDENT

March 15, 1984

Honorable Richard G. Lugar, Chairman
Subcommittee on Agricultural Research
and General Legislation
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairman Lugar:

As we approach the mid-term of the review period which Congress set for NFA in 1982, I am pleased to report that NFA is very much on target in all areas. In the words of your former House colleague Bill Wampler, who now serves as an NFA public director: "NFA is doing what Congress intended."

In the pages that follow we explain in some detail what we are, where we are, and where we plan to be. The story is a remarkable one, I believe, because just two short years ago the very existence of NFA was much in doubt. The CFTC had proposed a transaction tax that threatened to destroy the NFA concept which Congress had encouraged and nurtured since 1974.

At that time -- in February of 1982 -- NFA Chairman Leo Melamed appeared before Congress and said:

> We can do much . . . through self-discipline, at our cost. We ask you to give us that chance. We ask you to give NFA the chance to take part in the self-regulatory process that the industry knows how to do, can do, is offering to do, and will do.

You gave us that chance. And thanks to your encouragement and wise judgments in 1982, the futures industry is stronger and better policed today. Our programs and systems for customer protection are second to none.

Respectfully submitted,

Robert K Wilmouth
Robert K. Wilmouth

I. NFA IN BRIEF

(a) Nature. NFA is a not-for-profit membership corporation formed in 1976 to become the futures industry's self-regulatory organization under section 17 of the Commodity Exchange Act. Section 17 was added to the Commodity Exchange Act by Title III of the Commodity Futures Trading Commission ("CFTC") Act of 1974 and provides for the registration and CFTC oversight of self-regulatory associations of futures professionals. NFA's formal designation as a "registered futures association" was granted by the CFTC on September 22, 1981, and the first of NFA's regulatory operations began on October 1, 1982.

The final NFA plan, as approved by the CFTC in 1981 and made operational in 1982, provides for a phase-in of NFA programs. This plan evolved from numerous meetings and discussions between NFA organizers, futures industry leaders and CFTC officials; from legislative efforts in 1978 to perfect section 17; and from a sober and realistic assessment by NFA organizers of both the benefits and limitations of a registered futures association.

(b) Principal Features. NFA has four main regulatory activities: (1) Auditing and conducting surveillance of Futures Commission Merchant ("FCM") and Introducing Broker ("IB") Members to enforce compliance with NFA financial requirements; (2) establishing and enforcing rules and standards for customer protection; (3) conducting arbitration of futures related disputes; (4) performing screening to determine fitness to become or remain an NFA Member. At the present NFA's programs are operational for FCMs, IBs, Commodity Trading Advisors ("CTAs"), and Commodity Pool Operators ("CPOs").

In addition, and as authorized by section 17, NFA contemplates assuming registration functions under the Commodity Exchange Act -- functions now performed by the CFTC. NFA is already performing this role with regard to IBs and their Associated Persons ("APs").

Membership in NFA is open to any person registered with the CFTC, all futures exchanges, and any other person engaged in the futures business -- provided the applicant meets NFA's membership qualification standards. Eventually, when NFA's regulatory programs become fully operational, Member employees who are "associated persons" under the Commodity Exchange Act will be required to register with NFA as "Associates."

By virtue of NFA Bylaw 1101 and CFTC Rule 170.15, membership in NFA is mandatory for any FCM, IB, CTA, and CPO that transacts futures business with the public.

(c) Objectives. From the beginning, NFA's leadership recognized that NFA must benefit both the public and the futures industry to reach its full potential. To accomplish this, two basic objectives were set, which are incorporated in NFA rules approved by the CFTC:

> (1) More effective policing by the futures industry itself of those segments operating outside the system of exchange standards and surveillance.
>
> (2) Better cost control over regulatory expenses by eliminating duplication, overlap, and conflict between existing governmental and self-regulatory programs, and by facilitating a reduction in the cost of federal regulation -- for the benefit of taxpayers in general and market users in particular.

II. NFA'S STRUCTURE

(a) Board of Directors - NFA's Board of Directors is composed of 39 directors as follows:

Each exchange Member of NFA is represented on the Board. (All ten independently operating U.S. futures exchanges are Members.) One seat is allocated to each exchange having 20 percent or less of the total futures volume on U.S. futures markets during the preceding year, while exchanges with more than 20 percent of total annual volume have two seats on the Board. Presently there are 12 exchange representatives, with the Chicago Board of Trade and the Chicago Mercantile Exchange each having two representatives.

14 directors represent FCM Members of NFA; FCMs with from one to 15 offices have four seats, as do FCMs with from 16 to 50 offices. FCMs with more than 50 offices have six seats.

10 directors serve from the "Industry Participant" category. Specifically, CPOs have two seats on the Board; CTAs have three seats; commercial users of the markets have three seats; and commercial banks have two seats.

Finally, three seats are held by "public" directors -- i.e., individuals with no present direct affiliation with the futures industry.

With the exception of the exchange and public director categories, not more than one-half of the Board members in any of the representational categories may be from the same geographical "Region".

(b) Executive Committee -- While all decisions about Bylaws, budgets, funding, plans and priorities are made by the full NFA Board, it is too large to serve as the daily overseer of NFA management. Thus an Executive Committee has been created to perform that function.

Under current NFA rules, the Executive Committee has nine members. The President is a member, as are eight directors including the Chairman of the Board. Two directors represent exchange members -- one for an "over-20 percent" exchange and one for a smaller market (but the two individuals must be from exchanges located in different Regions). Three FCM directors serve on the Executive Committee, but not more than two are from the same Region. There are two representatives from the Industry Participant category (other than commercial banks), but they are from different categories and different Regions. (For example, two CPO directors cannot serve on the Executive Committee at the same time; nor can the two Executive Committee members in the Industry Participant category be from the same Region, even though they represent different categories). Finally, one public director serves on the Committee.

Because the Executive Committee is organized along category lines, the members are elected by the directors in that particular category. The public director on the Committee, however, is elected by the full Board.

(c) Regions -- The "region" restrictions on both the Board and the Executive Committee are designed to assure geographical balance. Three such Regions are defined: Eastern, Central and Western; and particular States have been assigned to each Region.[1/] The regional delineations are based upon three factors. First, certain industry participants relate primarily to the New York financial community; others to Chicago; and still others have no strong affinity to either location. Second, each Region has been defined to assure that there are at least several exchanges in each. And, third, the Regions have been defined in a way that results in a comparable number of NFA Members situated in each of the Regional groupings.

[1/] Eastern Region: Maine, New Hampshire, Vermont, New York, Massachusetts, Rhode Island, Connecticut, New Jersey, Pennsylvania, Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina and South Carolina.

Central Region: Ohio, Kentucky, Tennessee, Georgia, Florida, Alabama, Mississippi, Michigan, Indiana, Illinois, Wisconsin, Iowa, Arkansas and Texas; and Puerto Rico, the U.S. Virgin Islands and the Canal Zone.

Western Region: Minnesota, Missouri, Louisiana, North Dakota, South Dakota, Nebraska, Kansas, Oklahoma, New Mexico, Colorado, Wyoming, Montana, Idaho, Utah, Arizona, California, Nevada, Oregon, Washington, Alaska, Hawaii; and any U.S. territory or possession not included in the Central Region.

(d) Election to the Board -- The Board (except as indicated below) is elected by the Members of NFA, at an Annual Election held in January of each year.

The Member exchanges need no election since all have seats on the Board and, in the case of the "two-seat" exchanges, that selection is based entirely on published volume statistics.

In the case of other directors (except the public directors), candidates can emerge from three sources. First, NFA's Nominating Committee presents a slate of candidates. Second, 50 or more NFA Members in a particular category can nominate a candidate by filing a petition. Third, any association recognized by NFA as fairly representing a particular category of Members may nominate candidates in that category.

Nominees receiving a plurality of votes in their respective category (*e.g.*, the FCM directors will be elected solely by the FCM Members) are elected unless the winning candidates are subject to the regional or one-representative-only restrictions discussed above. In that event, the eligible candidate having the most votes is elected. A person that is a "dual" Member of NFA (*e.g.*, a firm that is both an FCM and a CPO) is permitted to vote only in that category to which its business activities primarily relate.

The public directors are elected by the full Board from a list of candidates compiled from Members.

Each elected and public director serves for a three-year term. The terms of the members of the initial permanent Board elected by the membership in 1983 were staggered, however, to assure continuity. In the exchange category, each representative serves at the pleasure of the particular exchange. If an exchange with two seats fails to remain in the "over-20 percent" category, one of its directors must vacate office at the beginning of the year following the disqualification. Likewise, if another exchange rises into the "over-20 percent" bracket, it will assume a second seat at the beginning of the next year.

(e) Mandatory Membership - In 1978, Congress amended section 17 of the Commodity Exchange Act expressly to permit NFA to have rules resulting in mandatory membership. NFA's Articles of Incorporation seek to achieve this result with respect to certain futures professionals. Basically, the Articles as implemented by Bylaw 1101 prohibit a Member of NFA from accepting futures orders from another person (except a direct customer) unless that other person belongs either to NFA or another registered futures association.[2/] The requirement focuses on the flow of customer orders and, in effect, interrupts that flow if an ineligible person becomes involved.

One exception to the requirement is the handling of orders by floor brokers. Floor brokers are regulated by the exchanges where they conduct business, and not by NFA. Thus, floor brokers are not compelled to join NFA in order to accept futures orders for execution. However, from the point of order origination (i.e., the first FCM, IB, CTA, or CPO) until the order reaches a floor broker for execution, only eligible persons may participate in the order flow.

III. NFA'S REGULATORY OPERATIONS

(a) Financial Requirements -- One of the principal functions of NFA is to establish, audit and enforce minimum financial requirements for its FCM and IB Members and to receive and analyze financial reports from those Members. No such requirements currently are established under NFA rules for other Members of NFA, such as CPOs and CTAs. NFA's financial compliance functions for exchange-member FCMs have been delegated by NFA to the exchanges, although at the request of an exchange NFA may perform those functions for such FCMs.

NFA financial requirements are patterned after exist-

2/ In addition, CFTC Rule 170.15 requires that every FCM required to register as such must be a member of a registered futures association.

ing financial standards of the CFTC and futures exchanges. Certain financially-related matters, such as the setting of levels of margin, remain exclusively with the exchanges (although NFA retains authority to require Member FCMs to collect margins in accordance with exchange requirements).

(b) Ethical Standards -- The ethical standards adopted by NFA include those specifically required by section 17 of the Commodity Exchange Act, such as prohibitions against fraud, manipulative and deceptive acts and practices, and unjust or inequitable dealings. In addition, bucketing is prohibited, and there are required procedures for the supervision of employees and the handling of discretionary accounts that are similar to CFTC requirements. In addition, CTA and CPO Members are required to follow specific CFTC rules; and detailed rules have been prescribed for exchange-traded options transactions.

(c) Members and Associates -- Membership in NFA is available to any CFTC registrant, any futures exchange, and any other person engaged in the futures business, unless the registrant, exchange, etc., is subject to one of the specified membership disqualifications (e.g., a CFTC order revoking registration). Eventually each employee of a Member of NFA who is an "associated person" under the Commodity Exchange Act will be required to register with NFA as an "Associate." These individuals will be subject to the same admission requirements as Members.

(d) Membership Screening -- When NFA programs become fully implemented, a first and important step in the regulation of NFA Members and Associates will be the screening of applicants for membership and registration as Associates. The initial screening process is handled by NFA staff. Final decisions on admittance are made by a committee of NFA directors (the Membership Committee) following a hearing, if the President finds there is reason to believe that an applicant may not be qualified for membership or registration with NFA as an Associate, and the applicant or the Membership Committee seeks a hearing.

(e) Disciplinary Proceedings -- NFA has an Office of Compliance responsible for financial auditing and ethical surveillance, under the supervision of a Director who is NFA's Vice President-Compliance. In the event of a possible infraction of NFA rules, a report is prepared and submitted to a nine-member Business Conduct Committee comprised of individuals connected with NFA Members in the NFA Region where the subject Member or Associate resides. The Committee acts on the report by either closing the matter or serving a formal complaint on the Member or Associate. In the latter event, the respondent must answer and is entitled to a hearing before the Committee. If the matter is not settled, and a decision is rendered against the respondent, that Member or Associate may appeal the decision to a committee of directors created by the Board for that purpose (the Appeals Committee). The decision on appeal is final, subject to review by the CFTC.

NFA has authority to discipline any Associate and any of its Members (other than floor brokers, all of whom are subject to exchange regulation) that are required to be registered with the CFTC.

The penalties that may be assessed include expulsion, suspension for a fixed period, a prohibition upon being associated with a Member, censure, reprimand, a fine not to exceed $100,000 for all violations, or any other appropriate penalty or remedial action. When emergencies occur -- i.e., there is imminent danger to the markets, customers or other Members -- a summary action may be taken by the President (if concurred in by the Executive Committee or Board), either with or without hearing. If no hearing is held before the action is taken, the Member will be afforded an opportunity for a hearing before the appropriate Business Conduct Committee as promptly as possible.

(f) Arbitration Proceedings -- Another principal function of NFA is to provide a centralized, uniform arbitration system. Section 5a(11) of the Commodity Exchange Act contemplates that this system may remove the present burden on exchanges to maintain their own customer arbitration programs -- that is, that the exchanges may "delegate" to NFA their responsibility to hear these disputes.

When fully operational, NFA's arbitration system will hear any futures (including options) dispute upon application of a customer against an FCM, IB, CTA, or CPO Member, or its employees or Associates. Counterclaims against the customer involving the same events also will be heard. The possibility exists, in NFA's discretion, to hear other disputes as well (e.g., disputes between Members).

Arbitrations are heard by panels of one or more arbitrators appointed by the President; customers generally have the right to a "mixed" panel. Claims of $5,000 or less generally will be resolved by a single arbitrator; claims under $2,500 are decided entirely through written submissions, unless NFA's Secretary directs otherwise. Proceedings are informal; however, parties may be represented by counsel. No appeal is permitted. Awards may be enforced in any court of competent jurisdiction.

IV. A MID-TERM REPORT

(a) Introduction. In authorizing the establishment of registered futures associations, such as National Futures Association, Congress clearly defined the purpose: ". . . to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, in general, to protect the public interest, and to remove impediments to and perfect the mechanism of futures trading." In sum, to assure -- through self-regulation -- high levels of professional conduct and competence, and high standards of financial integrity, on the part of individuals and organizations which conduct futures business with the public.

The challenge of NFA's first 15 months of operations -- and indeed the major accomplishment -- has been the creation and the implementation of the capability to achieve these objectives, effectively and efficiently.

(b) The Most Important Component. Nothing can be accomplished except by people. Thus, in every area of its activities and at every level of its organization, NFA has recognized that quality of performance begins with quality of people. Executive and managerial personnel were selected for their depth of experience and diversity of backgrounds -- the common denominator being a sound and comprehensive understanding of the business of futures trading.

To build upon this foundation of experience and professionalism, heavy emphasis has been placed, from the outset, on training and recruitment. As additional personnel have been required to carry out NFA's expanding responsibilities, NFA has interviewed at major universities to employ young men and women of demonstrated ability, primarily with backgrounds in accounting and finance.

(c) The Compliance Responsibility. Compliance, first and foremost, is what NFA is about. Approximately half of the total staff is engaged in activities -- principally auditing -- directly related to compliance.

NFA has been named the Designated Self-Regulatory Organization [DSRO] for 80 of the nation's Futures Commission Merchants (those not members of a futures exchange) and is front-line regulator for the approximately 1,000 Commodity Trading Advisors and Commodity Pool Operators which have become NFA Members.

Compliance encompasses a variety of activities -- financial surveillance, field examinations and special investigations -- designed to prevent violations of NFA rules whenever possible and initiate prompt corrective or punitive actions whenever necessary. Firms and individuals subject to NFA compliance requirements must maintain complete, accurate and up-to-date records, remain properly capitalized, segregate and account for customer funds, and adhere to ethical and honest business and sales practices. To enforce these rules, a total of 342 examinations were conducted by NFA auditors through February of 1984. Auditors currently operate from NFA offices in Chicago and New York.

Additionally, in 40 instances, daily financial surveillance of firms handling customer funds found possible rule infractions and led to appropriate NFA action. And, in response to indications of potential serious rule violations -- stemming from audits, referrals or public complaints -- NFA staff conducted a total of 106 preliminary inquiries which led to 13 full scale investigations.

Consistent with NFA's responsibility to protect the public interest, compliance personnel routinely monitor magazine and major newspaper advertising, sales literature and other solicitations involving or appearing to involve futures contracts. Also screened are advertisements for employment in the futures industry, particularly for sales personnel. In all instances, the objective is to assure that persons considering futures transactions receive adequate, accurate and straight-forward information on which to base their trading decisions.

(d) State of Art. New has advantages. For NFA, being a newly-created organization has provided the opportunity to utilize state of the art technology in data processing and communications. FACTS -- the acronym for the Compliance Department's unique Financial Analysis, Audits, Compliance Tracking System -- is an on-line, computerized system specifically designed to meet NFA requirements. Developed during 1983 and scheduled for programming and testing in 1984, the system will provide a sophisticated capability to monitor Member firm compliance with financial requirements and other rules and will make historical as well as current data immediately available to NFA personnel via desktop terminals.

FACTS has been designed to isolate and identify "exceptions." It will continuously pool available data to provide an early warning of potential problems, such as identifying a firm whose financial situation may require closer scrutiny or immediate action.

Another advantage of FACTS is that it can be readily programmed to make information terminal-accessible on a restrictive "need to know" basis -- an often-important consideration in dealing with data that, in some instances, is highly confidential. Still another feature is its ability to track the locations and schedules of field audit personnel.

Indeed, the system will even have a "human side." It can help supervisors avoid making frequent "foul weather" geographic assignments to one audit team and "fair weather" assignments to another.

Most importantly, FACTS will provide the flexibility to respond to the continuously changing needs of what is clearly one of the nation's most rapidly growing and innovative industries.

(e) A Helping Hand. NFA compliance rules and regulations are admittedly both strict and comprehensive and, for some firms -- firms not previously subject to self-regulation -- they have mandated the adoption of new and unfamiliar accounting and business practices. [Prior to the creation of NFA, Commodity Pool Operators and Commodity Trading Advisors were generally not subject to self-regulation.] An important effort has thus been to assist Member firms in whatever ways and to what ever extent possible in achieving a high level of voluntary compliance.

NFA believes, and experience confirms, that many potential violations can be avoided through an understanding of regulatory requirements and the steps necessary to achieve compliance. NFA auditors and other staff professionals welcome the opportunity to provide such assistance.

(f) And A Firm Hand. As evidenced by its record of disciplinary actions, however, NFA possesses both the authority and the determination to deal swiftly and appropriately with violations of its rules. The knowledge that serious and flagrant rule violations can result in expulsion from NFA membership -- and a permanent prohibition against engaging in any business involving futures trading -- provides a compelling incentive for compliance. The helping hand is also a firm hand.

Depending on the nature of the violation and the immediacy of the threat posed to either customers or to the futures industry, NFA disciplinary actions take a variety of forms:

Warning Letters. These are issued by an NFA Business Conduct Committee in instances where a formal complaint is not warranted but it is deemed necessary to place the Member on notice that further violation may cause the Committee to take more serious disciplinary action. Warning Letters are not made public. Through February 1984, 19 Warning Letters had been issued to Member firms.

Complaints. The Business Conduct Committees issue formal Complaints when serious rule violations occur. A Complaint, which is a matter of public record, may result in a fine of up to $100,000 as well as other disciplinary actions -- including suspension from NFA membership. Through February of 1984 the Committees issued 13 Complaints.

Member Responsibility Actions. These are summary actions taken by the NFA President with the concurrence of the Executive Committee in situations where an immediate risk to customers or the industry requires an immediate remedy. A firm may, for example, be ordered to cease and desist from the violating practice; it may be barred from soliciting or from making any additional futures transactions; or its NFA membership and right to participate in futures markets may be suspended. Member Responsibility Actions are reviewable by a Business Conduct Committee at the request of the Member. Through February 1984, 18 infractions of NFA rules resulted in Member Responsibility Actions being taken.

(g) Options. As a result of the efforts of NFA, the door to participation in the pilot program for options on futures contracts has been opened to all NFA Member Futures Commission Merchants, including those not members of any exchange. Prior to CFTC approval of NFA compliance rules for the regulation of the options-related activities of its Members, only those FCMs which were members of an exchange could accept or transact options business. And they could buy, sell and handle orders only for the particular option (or options) traded on the exchange (or exchanges) where they were members. NFA regulation has made it possible for all NFA Member FCMs, whether or not an exchange member, to solicit and accept options orders on any and all U.S. exchanges.

(h) Cooperation. Although the regulatory domain of NFA encompasses only firms and individuals engaged in the futures business, close and continuing relationships have been established with organizations and agencies responsible for regulating other types of investment activity. And, of course, where futures contracts are involved, NFA fully cooperates with the CFTC.

To assist in combating fraud by persons or firms that do not come under the regulatory jurisdiction of either NFA or the CFTC, a senior NFA staff member has been named Enforcement Liaison to all 50 states through the North American Securities Administrators Association (NASAA). Potentially fraudulent or suspicious activities by non-NFA members are referred to the CFTC, appropriate state authorities, the Securities and Exchange Commission (SEC), and/or to such organizations as the National Association of Securities Dealers, Inc. (NASD). Conversely, when violations or questionable activities by NFA Members are encountered by these organizations, referral is made to NFA.

When NFA's computer systems are fully operational, NFA will serve as a national clearing house for registration/membership and disciplinary history information relating to the entire futures industry. At present, such information is housed separately in files at exchanges, the NASD, SEC, CFTC, and the states, as well as NFA.

(i) Membership. Clearly a major first challenge -- and just as clearly a major achievement -- was the effort to secure and process applications for membership in NFA. Under rules promulgated by the CFTC in 1983, all Futures Commission Merchants doing customer business must become NFA Members. (Even before the mandatory membership requirement became effective, 96% of these FCMs had voluntarily joined NFA.)

As a practical matter -- because NFA bylaws prohibit FCM Members from conducting futures business with any non-NFA member professional who acts on behalf of customers -- membership in NFA is effectively mandatory for all categories of persons and organizations registered with the CFTC (other than floor traders and brokers). In addition to FCMs, this currently includes Commodity Pool Operators, Commodity Trading Advisors and Introducing Brokers. Any of these individuals or firms that do not meet the requirements for CFTC registration are not eligible for NFA Membership.

As of February 29, 1984, a total of 338 Futures Commission Merchants, 434 Commodity Pool Operators, 406 Commodity Trading Advisors, and 54 Introducing Brokers had become NFA Members (multiple membership categories excluded).

Additionally, all 10 independently operating U.S. futures exchanges, 3 commercial banks, and 3 commercial firms have joined on a voluntary basis.

(j) Registration/Screening. On August 1, 1983, NFA assumed the responsibility of registering, on behalf of the CFTC, a new category of futures professionals: Introducing Brokers (IBs) -- persons previously known as agents of Futures

Commission Merchants. Also assumed by NFA was the responsibility for registering Associated Persons (APs) of Introducing Brokers. As of February 29, 1984, applications for registration have been received from over 700 Introducing Brokers and 6,000 Associated Persons. Completion of the registration process was delayed by application deficiencies (more than four-fifths of all applications received) and by the fact that the registration responsibility was assigned prior to NFA's computerized registration system becoming operational, requiring manual processing.

Soon to be initiated is a program of temporary licensing. To expedite registration, applicants meeting certain qualifications will be issued temporary licenses pending a complete review and examination of their applications.

Registration is by no means automatic. Names are checked -- both internally against NFA records and externally with the CFTC and SEC -- to determine if the applicant has been the subject of previous disciplinary action, and fingerprints are forwarded to the FBI to check for any criminal record.

NFA registration personnel actively cooperate and maintain a close liaison with their counterparts in other agencies and organizations.

(k) The System. During 1984, it is anticipated that NFA will become responsible for the registration -- for the CFTC -- of all or virtually all categories of futures professionals: Futures Commission Merchants, Commodity Pool Operators, Commodity Trading Advisors and Associated Persons in each of these categories. This will be in addition to the present responsibility for registering Introducing Brokers and their Associated Persons As and when this occurs, it will require the establishment and maintenance of records for more than 100,000 individuals and 4,000 firms. NFA has begun operational testing of a sophisticated computer system equal to the task, and equal to the growth of the task.

MRRS -- Membership Registration and Receivables System -- will not only automate registration and membership operations but will provide the capability to monitor accounts receivable and provide immediate access to a "file" on each registrant and Member, including any publicly available information concerning disciplinary actions taken against a firm or individual.

(l) Testing. Concurrently with accepting the responsibility for registering Associated Persons of Introducing Brokers, NFA's Board of Directors adopted a Bylaw requiring all new applicants for this category of registration to have taken and passed a proficiency test: The National Commodity Futures Examination. It was the first time any category of applicant had been required to take a competency examination as a condition for CFTC registration.

This requirement will be expanded. As NFA assumes registration responsibility for other categories of futures professionals, passing an examination will be a registration requirement for all new applicants.

(m) Arbitration Program. Yet another important accomplishment has been the development and implementation of the NFA arbitration program. Its purpose is to provide a fair as well as a generally faster and less expensive means of resolving futures related disputes such as between customers and individuals or firms with which they do business or, under certain circumstances, between two customers or two NFA Members.

The NFA arbitration system became operational on March 31, 1983. As of March 12, 1984, a total of 132 requests had been received for information pertaining to arbitration, 137 notices of intent to arbitrate had been filed, and 58 Demands for Arbitration had been made. Nine claims have been settled prior to hearing. Eleven cases have been resolved through hearing and award, and 18 others are ready for hearing. The average time from filing to resolution has been six months.

The opportunity to seek resolution of a disagreement through arbitration is available to any customer of an NFA Member firm (unless some other method has been agreed to previously). Decisions of the arbitration panel are binding on both parties, non-appealable and enforceable in any court of competent jurisdiction.

One goal of the NFA arbitration program is convenience. To minimize the need for travel by participants and witnesses in cases requiring hearings (claims involving $2,500 or more), NFA attempts to schedule arbitration proceedings at locations as close as possible to both parties. NFA has selected approximately 246 qualified arbitrators in 29 states. Claimants have the option of choosing arbitration by panel members who have -- or do not have -- a connection with NFA or NFA Members.

(n) Legal Activities. In addition to establishment of the arbitration program and involvement in matters pertaining to routine operations, NFA's professional legal staff responded to the on-going challenge of effectively carrying out NFA's regulatory responsibilities and preparing for the scheduled assumption of still more extensive responsibilities. Major activities include:

Augmentation of rules to enhance the regulation of Commodity Pool Operators and Commodity Trading Advisors.

Development of the procedures and rules necessary to conduct CFTC registration activities.

Drafting of complaints and the development of legal strategies relating to disciplinary matters.

(o) The Year -- And Years -- Ahead. An immediate, 1984 priority is to bring to operational status NFA's two recently-developed computer systems: FACTS for compliance surveillance and MRRS for functions related to registration and membership. This will facilitate the expansion of registration responsibilities (to include Commodity Pool Operators, Commodity Trading Advisors, Futures Commission Merchants and their Associated Persons) as well as increase and enhance auditing capabilities.

At some time during 1984, it is anticipated that NFA will be named the Designated Self-Regulatory Organization for those Introducing Brokers who are not guaranteed by a Futures Commission Merchant. It is also possible that some exchanges may elect to delegate to NFA the responsibility of performing financial audits of exchange Member firms.

The arbitration program will be -- and, indeed, already is being -- substantially expanded. Additional qualified arbitrators will be selected in additional states. And, high on the list of priorities, a major effort will be made to increase public awareness of the availability of arbitration as well as other NFA functions and benefits. A booklet providing a plain-language explanation of the arbitration process is scheduled to be published early in 1984.

The delegation of increased responsibilities to NFA will necessitate some increase in staff. Such increases, however, will be largely in the compliance area (from 60 auditors to approximately 100 during the months ahead) and in the area of registration. No significant increase in administrative support personnel is presently anticipated.

Plans for the eventual proficiency testing of all new futures professionals are being accelerated. Specific tests will be developed for specific categories of applicants.

Whenever and wherever available, opportunities will continually be sought to work more closely with other organizations -- including futures exchanges, the CFTC, NASD, SEC and state agencies -- in an effort to reduce duplication, create uniformity and improve regulatory effectiveness.

In these and in all of its endeavors, it is the principal and continuing goal of NFA to provide proof through performance that effective and efficient regulation of the futures industry can be best achieved through self-regulation.

V. GENESIS OF THE NFA CONCEPT

(a) Initial Industry Concerns. Section 17 of the Commodity Exchange Act, creating the possibility of a "futures association" within the futures industry, was originally known as Title III of the Commodity Futures Trading Commission Act of 1974. Like most other provisions of the CFTC Act, section 17 became effective in April of 1975. For more than a year after that date, however, no effort was made within the futures industry to make use of section 17 to form a futures association.

A principal concern of industry lenders was that a futures association might simply add a new regulator with new requirements. Already, many futures professionals were confronted with multiple regulators. While increasing the cost of doing business, this new regulator might serve no useful purpose for either the industry or the public.

Also, section 17 clearly contemplated an organization akin to the National Association of Securities Dealers ("NASD"). The NASD, however, was formed to regulate the over-the-counter securities business that operates outside of the system of stock exchange self-regulation. There is no "over-the-counter" futures business, however. In fact, the Commodity Exchange Act prohibits it; all futures trading must take place on organized exchanges, through exchange members and under self-regulatory oversight.

A further concern, particularly within the exchange community, was whether a futures association would set standards or impose requirements in conflict with the rules of the exchanges, so that members of both entities would face incompatible duties. Frequently, the members of a futures association would also belong to one or more exchanges, and all of their futures transactions would pass through the exchanges.

Obviously, the futures association and the exchanges would have to work closely together if conflicts were to be avoided.

(b) FIA Proposal. While these issues were still under debate within the industry, a proposal was submitted in August 1976 by the Futures Industry Association ("FIA") to the CFTC. The FIA proposal called for the formation of a futures association limited initially to the screening of associated persons, but with the potential eventually to set a wide variety of standards governing the relationship between futures firms and their customers. Because FIA is not organized as a self-regulatory organization, however, it advised the CFTC that it would be necessary to make major changes in FIA bylaws and devote considerable time and effort to develop a funding plan.

FIA's proposal had two principal features. First, its regulatory program applied only to FCMS, CPOs, and CTAs. (Thus, it focused on those firms dealing directly with the trading public.) Second, its regulatory efforts were to be limited to "off-exchange" activities such as customer relations, advertising, and the financial strength of firms doing business with the public. According to the proposal, FIA would not become involved "with other aspects of regulation which would relate to the workings of the marketplace, such as floor operations, contract details, prevention of manipulations and financial integrity of clearinghouses, etc."

Thus, this earliest proposal for a registered futures association recognized two essential features of any futures association: membership must be defined along functional lines -- doing business with the public, regardless of statutory label -- and conflicts with the self-regulatory programs of the exchanges must be avoided.

(c) Industry Response. One month after the FIA proposal reached the CFTC, Leo Melamed of the Chicago Mercantile Exchange met with the chairman of the Chicago Board of Trade, Paul McGuire, to discuss this development and to

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exchange views on whether the exchanges should take an active part in the development of a futures association. As a result of conversations with FIA officials, they were aware that FIA preferred that a separate, distinct entity act as the Title III Organization (rather than FIA); and that FIA's proposal primarily was made to draw industry support for the concept of a national futures association and to spur others within the industry into action.

After careful analysis, Mr. Melamed and Mr. McGuire concluded that a Title III Organization would unquestionably benefit the legitimate interests of the futures industry and the public it serves, but that such an organization must be broadly-based and provide for participation by the exchanges. They agreed to proceed on that basis. FIA, when advised of this decision, immediately concurred and offered its support.

In September 1976, articles of incorporation were developed under the direction of Mr. Melamed and Mr. McGuire and National Futures Association was chartered in the State of Delaware. The purposes of NFA were defined generally at that time, but with the realization that the articles of incorporation as originally written would serve principally as a basis for negotiation within the industry and with the CFTC.

(d) Motivating Factors. Several industry developments gave momentum to the idea of a futures association and motivated both FIA and the NFA incorporators. First, the 1974 amendments to the Commodity Exchange Act expressly recognized the existence of futures industry professionals operating largely beyond exchange supervision -- CPOs and CTAs, for example. The CFTC had found through its registration process that these persons numbered in the many hundreds.

Second, each month brought the futures industry closer to fully-negotiated commission rates which, in turn, would reduce the economic incentive for commercial firms and some FCMs to belong to exchanges (where, previously, members alone received discounts on commission rates). This meant that, as the futures industry grew, many new FCMs might choose not to join an exchange, in order to avoid complying with rigorous exchange financial and ethical requirements and scrutiny.

In fact, the number of industry participants operating without exchange supervision was already higher than expected and was certain to increase in the years to come. This could prove to be a danger to the proven fiscal integrity of the futures market system. And while the CFTC could expand in dollars and staff to meet this challenge, a self-regulatory association was the better answer. The self-regulatory philosophy was strong in the futures industry and had a long history, beginning with the founding of the Chicago Board of Trade in 1853.

Additionally, the futures association concept received support from within the industry because it offered the promise of greater efficiency in the self-regulatory process. Self-regulation in the futures industry had become complex. A number of autonomous exchanges existed, each with its own rulebook, its own surveillance staff, and its own disciplinary system. Any brokerage firm belonging to more than one exchange sometimes faced duplicative self-regulatory programs at a minimum, and many also confronted conflicting exchange requirements. Therefore, a national self-regulatory association like NFA offered the hope that some of these piecemeal functions over time could be coordinated and even consolidated.

Finally, a futures association was regarded by many futures industry leaders as the next and necessary step in the evolution of futures markets. The U.S. futures industry had reached a level of national and international visibility and participation that demanded a unified national association which, for certain specific purposes, could bring within its fold all the different exchanges, diverse interests, and multitude of market users. Logic dictated the creation of a national association which could act as the coordinated self-regulatory body for the entire industry in specific areas critical to the continued growth, viability and well-being of futures markets and the business communities which they serve.

(e) Building Consensus. In October of 1976, Mr. Melamed and Mr. McGuire extended invitations to five other industry leaders to form an NFA organizing committee reflecting regional considerations as well as differences in business activities. To reflect regional considerations, three invitees were from New York City and two were from Chicago. To accommodate differences in types of businesses, three invitees were officials of major brokerage houses, while firms specializing in commodities were represented also. The exchange community was represented through Mr. Melamed and Mr. McGuire, and by the president of the Chicago Board of Trade. Other invitees had occupied leadership roles at the New York markets. Three of the invitees, moreover, had been leaders of FIA at the time of its original proposal to the CFTC. All accepted.

In December of 1976, the organizing committee met in New York with representatives of the various exchanges and FIA to outline its proposal. From that meeting came a consensus that the NFA organizing committee should continue to work toward a futures association utilizing the concepts discussed at the meeting.

On February 10, 1977, the CFTC heard the proposal of the NFA organizing committee and, five days later, announced that it "endorses this concept of cooperative regulation and considers the NFA proposal to be a valuable first step toward implementing the purposes of Title III."

In June of 1977, the NFA organizing committee returned to the CFTC with the view that neither NFA nor any other futures association could be an effective self-regulator if eligible industry participants could refuse to join or, once members, could resign at the first sign of disciplinary action. The organizing committee urged that it have the tools to avoid such a "revolving door" syndrome. On June 7, 1977, the CFTC agreed: "The Commission, as a matter of policy, approves the concept of 'uniform required membership' as proposed by the N.F.A. organizing committee."

(f) Antitrust Division Objections. In October of 1977, however, without any contact whatsoever with NFA, staff members of the antitrust division of the U.S. Department of Justice released to the media and the CFTC a lengthy legal memorandum attacking the NFA proposal and, in particular, the concept of mandatory membership. The antitrust division authors raised constitutional questions, argued that Congress had not "intended" that membership in a futures association be compulsory, and expressed the view that there should be many competing futures associations.

(g) Congress Responds. After carefully reviewing the antitrust division memorandum, the NFA organizing committee filed a detailed reply with the CFTC in January 1978 addressing each of the arguments made. The issue was not resolved, however, until completion later that year of the 1978 CFTC reauthorization process. Section 17 of the Commodity Exchange Act was amended expressly to sanction NFA's proposed mandatory membership concept, and to otherwise perfect section 17. The message was unmistakable: Congress wanted NFA.

(h) The Registration Process. During 1979 and 1980 many additional meetings were held to develop the details of NFA's formal submission to the CFTC; comments were prepared in response to the CFTC's proposed Part 170 rules governing futures associations; and extensive drafting was undertaken to develop NFA's application papers -- a 300-page legal document filed with the CFTC on March 16, 1981. This actual filing followed extensive industry briefings in February and early March of 1981 -- which resulted in even more fine-tuning.

NFA's application consisted of a detailed registration statement, as required by CFTC rules, and the following documents:

1) Articles of Incorporation -- NFA's "constitution" -- which contains a number of carefully drawn protections essential to a viable, effective Title III organization.
2) NFA Bylaws -- which provide the organizational and operational details.
3) NFA Compliance Rules -- which contain NFA's code of conduct, as well as the procedures for Member/ Associate discipline.
4) The NFA Code of Arbitration -- which provides for a system of customer-initiated arbitration.
5) NFA Financial Requirements -- applicable to Member FCMs.

In addition, in a "preliminary statement" to the application, the organizers summarized their principal motivations in proceeding with the ambitious NFA plan. See §VI.

Public comments were solicited by the CFTC and hearings were held before the CFTC on June 4, 1981. Speaking on behalf of NFA, organizing committee chairman Leo Melamed emphasized NFA's goal of integrated, coordinated self-regulation:

> In an era of deregulation -- long overdue in my opinion, and essential to the long-term health and economic survival of America -- it would be ironic, if not tragic, if NFA were to represent yet another layer of regulation. Duplicative, costly, inefficient, suffocating regulation. A fundamental goal of the NFA organizers has been -- and is -- to avoid just this.
>
> We do not want NFA to become but another regulatory layer. We do not want to duplicate existing self-regulatory efforts. Rather, we want to complement and perfect existing programs. Nor do we want to precipitate useless

> turf-battles. Rather, we want to recognize the essential, central role of the exchange community and draw upon its considerable talents and expertise. After all, they have done a remarkably fine job for over 100 years -- within their area of limited jurisdiction.
>
> Thus the NFA proposal of integrated, coordinated self-regulation is the only rational one -- the only one, we submit, that Congress could have intended. Our plan fully complies with the letter and spirit of the law. Moreover, it best reflects what is the essence of futures tranding: In the words of Holbrook Working, "futures trading is trading conducted under special regulations and conventions, more restrictive than that applied to any other class of commodity transactions, which [regulations and conventions] serve to facilitate hedging and speculation by promoting exceptional convenience and economy of transactions." Regulators -- self or otherwise -- must never lose sight of that.

Following extensive review, and analysis of further objections from the antitrust division and NFA's detailed response, NFA's registration was granted by the CFTC on September 22, 1981.

(i) 1982 Congressional Affirmation. Approximately four months later, however, the future of NFA was put in serious doubt, as the CFTC urged Congress to adopt a futures transaction tax. This novel tax, if enacted, would have deprived NFA of its funding base at a critical time and would have jeopardized futures industry support for the NFA concept. Congress soundly rejected the CFTC tax proposal, however, in favor of NFA.

In this connection, Congress comprehensively reexamined and significantly amended section 17 of the Commodity Exchange Act to enhance further the NFA role. Congress also affirmed that "every registered commodity professional, except floor brokers, must be a member of NFA in order to fulfill the 1978 congressional grant of authority to the CFTC to make membership in a registered futures association compulsory." [128 Cong. Rec. H7507 (daily ed. remarks of Rep. Wampler). Accord 128 Cong. Rec. S13097 (daily ed. remarks of Senator Percy).] The Committee of Conference on the Futures Trading Act of 1982 emphasized explicity that "under the Act, the Commission has authority to adopt . . . [CFTC Rule 170.15]" H.R. Rep. No. 964, 97th Cong., 2d Sess. 50 (1982).

In short, Congress in 1982 squarely faced the question whether NFA would have a meaningful place in the Commodity Exchange Act's regulatory scheme or whether direct governmental regulation by the CFTC would be preferred. See, e.g., 128 Cong. Rec. H7517 (daily ed. remarks of Rep. Volkmer). Congress selected the self-regulatory approach of NFA and section 17 of the Act. To that end, Congress also sought to ensure that NFA would fulfill the self-regulatory mission reflected in section 17. The 1982 Act therefore contains significant revisions to section 17 covering the assumption by NFA of CFTC registration functions, NFA rule approval procedures, expansion o NFA arbitration remedies, the establishment of performanc standards for NFA, and a broad study of NFA performance.

In the context of this vast array of amendments Congress expressly recognized "that unless all persons covere by the regulatory program of a futures association join a association, the self-regulatory purposes of section 17 of th Commodity Exchange Act will not be fulfilled and, in particular, the goal of new section 17(q) may be impossible achieve." H.R. Rep. No. 964, 97th Cong., 2d Sess. 49-50 (198 (Report of Committee of Conference).

New section 17(q) requires NFA to develop a comprehensive program that fully implements NFA's rules approved the CFTC. In enacting section 17(q), Congress thus made clear its appreciation of the nexus between the provisions of that section and mandatory NFA membership. Indeed, the Conference Committee report on section 17(q) contained the following directive to the CFTC.

> The conferees expect that the Commission will exercise . . . [its] authority and adopt such rules or take such other action as it deems to be necessary or appropriate to insure that persons eligible for membership in a registered futures association become and remain members of at least one such association.

H.R. Rep. No. 964, 97th Cong., 2d Sess. 50 (1982).

In 1982, therefore, Congress ratified the CFTC's mandatory NFA membership policy, directed in section 17(q) that NFA self-regulatory programs and rules be fully implemented, stated explicitly that mandatory futures association membership was necessary to effectuate that directive as well as the specific purposes of section 17, and emphasized its expectation that the CFTC would exercise its authority to accomplish fully the mandatory NFA membership objective.[3/]

VI. PRELIMINARY STATEMENT TO NFA'S MARCH 16, 1981 APPLICATION FOR REGISTRATION UNDER SECTION 17 OF THE COMMODITY EXCHANGE ACT

The National Futures Association (hereinafter "NFA") is the first applicant for registration under the Commodity Exchange Act (hereinafter "the Act") as a Registered Futures Association. Section 17 of the Act provides for the registration with the Commodity Futures Trading Commission (hereinafter "Commission") of one or more such associations.

Among the fundamental purposes of NFA is to relieve

[3/] On June 1, 1983 the CFTC adopted Rule 170.15 (effective August 8, 1983), which provides that each FCM required to register as such must become and remain a member of at least one registered futures association.

the Commission of a significant part of its current burden under the Act, especially in the direct regulation of futures commission merchants that have elected to operate without membership on the contract markets where they do business. With the Commission's consent, the NFA could also relieve the agency of much of the clerical burden connected with the registration and testing of associated persons. In all likelihood, the efforts of the NFA will allow the Commission to realize other savings in manpower and money as well.

The incorporators and organizers of NFA believe that the assumption by the private sector, through NFA, of a significant part of the Commission's existing burden is both prudent and desirable because it will enable the Commission to devote more of its scarce resources to duties under the Act which, if delayed or deferred, would have a serious adverse impact upon the continued growth of the commodity futures industry and would unnecessarily deprive the public (including businesses and institutions) of the expanding services of that industry.

In particular, the incorporators and organizers note already lengthy processing time at the Commission on such vital matters as approval of proposed new futures contracts; review of changes in contract market rules necessary to assure efficient exchange operations, to meet competition, and to better serve the public; inauguration of commodity options trading under exchange sponsorship; the resolution of customer claims made under the reparations program; and other matters.

The incorporators and organizers of NFA believe that the Congress has mandated the regulation of commodity futures trading because it recognizes the important role played by these markets in the economic life of this nation. As such, we believe that Congress' desire to regulate in the public interest was never intended to impede the honest operation or the natural growth of futures markets. We view the creation of NFA as an opportunity for the Commission to carry out that

Congressional intent, despite limited resources, and our decision to apply under Section 17 of the Act is motivated in substantial part by the expectation that duties of the Commission under the Act affecting industry growth and development can and will in the future be performed expeditiously.

TESTIMONY OF ALAN J. BRODY
PRESIDENT
COMMODITY EXCHANGE, INC.

Mr. Chairman and members of the Subcommittee:

I am Alan J. Brody, President of Commodity Exchange, Inc. or, as it is often called, COMEX. I am grateful for this opportunity to testify on the Commodity Futures Trading Commission's implementation of the important amendments made in 1982 to the Commodity Exchange Act. You, Mr. Chairman, and the members of the Subcommittee can be justly proud of that legislation.

As you know, COMEX is a futures market in New York City that has served the trading and hedging public for 50 years. Our products include futures contracts on gold, silver, copper and aluminum, as well as an option on gold futures. In 1983, COMEX volume exceeded 20 million futures contracts, placing it first among the metals exchanges.

As these figures attest, COMEX has much at stake in assuring that the Commodity Exchange Act works well, and that the Commission fulfills its mandate in an effective and responsible manner.

These hearings will cover a large number of subjects. Some of them -- such as reparations and registration matters -- can be addressed better by other witnesses since these are not programs that impact directly on COMEX. Instead, I would like to offer you my views on three topics: the CFTC's performance under the new procedures for contract market designations and exchange rule approvals; the Commission's regulation of leverage transactions; and the role of the States in the eradication of off-exchange fraud.

1. Designations and Rule Approvals.

The 1982 amendments to the Act were designed to streamline the Commission's process for approving new futures contracts, and for reviewing other rules that the markets wish to adopt. The amendments also set certain timetables within which the Commission must complete those tasks.

In the months since those amendments became law, COMEX has been generally pleased with the Commission's performance under them. We have found the Commission to be receptive to our needs, without sacrificing its duties in any way. There are still occasions, however, when the Commission's staff seems unduly preoccupied with minor and, to us, inconsequential details but, in the main, COMEX believes that the new procedures have worked well so far.

2. Regulation of Leverage Transactions.

Leverage contracts are off-exchange instruments that COMEX does not trade. Leverage contracts tend to be long-term agreements allowing customers to invest in various commodities through private companies as long as they maintain a certain minimum deposit and pay periodic carrying fees to the merchant. A number of leverage merchants offer instruments in precious metals and, therefore, can affect the public's attitude toward all forms of investment in these metals. Ever since the earliest off-exchange scandals, COMEX has been concerned that neither the futures industry nor the Commission becomes identified in the public's eye with peripheral types of business unless they are subject to the strictest possible regulation.

Any business where one party can set the price unilaterally, where the contracts are not guaranteed by a third party such as an exchange's clearinghouse, and where there is no public resale market for the contract, seems to us to be more troublesome than activity that takes place on competitive markets under the watchful eye of both a self-regulatory organization and government authorities.

For these reasons, COMEX has encouraged the Commission to develop and enforce a system of rigid regulation for leverage transactions. At a minimum, these regulations should take into account the customer's lack of bargaining power when it comes to both the prices charged and the terms imposed, as well as a customer's right -- without high-pressure sales tactics -- to know what are his real chances of making a profit in the transaction.

The Commission has already issued interim regulations which address some of these concerns. It has also requested comments on further changes in leverage regulations, one of which would allow merchants to offer contracts that reverse the roles of the parties and obligate a customer to deliver the commodity to the merchant. Since most customers cannot realistically be expected to have that ability, and this type of "short" leverage contract is very similar to futures, we hope that the Commission will exercise special caution before allowing that practice.

3. States' Role Against Criminal Fraud.

Congress has repeatedly determined that futures trading should be governed by a single, centralized, consistent body of rules. As a result, the Commission has exclusive jurisdiction over exchange-centered activity. COMEX believes that this arrangement is correct and that the history of Commission regulation since 1974 is conclusive proof of that fact.

But criminal fraud perpetrated away from the exchanges is another matter entirely. Here, cheating the public is not merely the result of an occasional errant employee. It is the career of full-time professionals who prey on the despair, naivete or greed of others. These criminals commit fraud wherever easy money can be made. This year, commodities may be their target. Last year, perhaps it was land sales, or securities, or mail order merchandise. Next year, it may be tax shelters or oil-and-gas leases.

The important point is that these operators cannot be treated like legitimate businesspeople. They will not submit to being licensed. They will not file reports with anyone. No investigator is allowed to pass through their doors. In short, these operators cannot -- and will not -- be regulated, by the Commission or anyone else.

COMEX is aware of interest in some quarters of Congress to somehow deal with the problem through federal regulatory agencies such as the Commission. We cannot agree with that approach. First, it makes no sense for the Commission to "regulate" what is already clearly illegal. Second, the Commission lacks the only tools that matter here: the power to arrest and imprison the offenders. And, finally, the Commission's resources are already fully committed to something that benefits rather than threatens society -- fair and efficient futures markets.

One of the greatest accomplishments of this Subcommittee and of Congress in 1982 was to empower genuine crime-fighting agencies such as the Federal Bureau of Investigation, the Department of Justice, and state law enforcement units to lead the campaign against criminal fraud. The criminal justice system is the only effective answer to this problem. We applaud Chairman Phillips and her colleagues for their renewed efforts to involve other federal and state agencies in this battle. I can assure you that COMEX also stands ready to provide whatever assistance it can.

In conclusion, COMEX believes that the provisions of the 1982 amendments affecting it are working reasonably well. Our concerns arise in the off-exchange area where the Commission must be especially vigilant. If that activity can be regulated at all, it must be policed rigidly. And, where hard-core crime is involved, strict criminal law enforcement by agencies with the power to arrest and imprison is the only effective way to protect the public.

At the appropriate time, Mr. Chairman, I will be pleased to answer any questions by the Subcommittee.

STATEMENT OF WILLIAM BRODSKY
EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER
CHICAGO MERCANTILE EXCHANGE

Mr. Chairman and members of the Subcommittee. We appreciate this opportunity to present our views respecting the implementation of those portions of the Futures Trading Act of 1982 pertaining to exchange operations. In general terms, we believe that the Commodity Futures Trading Commission has performed its statutory duties with diligence and efficiency. Moreover, the level of CFTC efficiency have not caused any sacrifice in the level of public protection which is provided by the exchanges and the NFA under the supervision of the CFTC is constantly improving.

The foregoing does not mean, however, that the Chicago Mercantile Exchange is perfectly satisfied with the current state of affairs or that we believe that improvements are not possible. Our objections are not directed specifically at the CFTC's performance of its statutory duties but, more basically, at the adverse consequences that follow from the imposition by Congress of certain duties and responsibilities on the CFTC. We believe, and most knowledgeable economists concur, that certain CFTC duties respecting contract approval, rule review, etc., which we will discuss below, either: are not cost effective when performed by a federal regulatory agency; are duplicative of existing, effective, private efforts; or are inefficiently performed by federal regulatory agencies. In addition, we believe that some of the amendments proposed by the exchanges during the course of the recent reauthorization proceedings ought to have been adopted and that their rejection has in fact lead to the very dangers warned of by the exchanges.1/

We understand that one of this Subcommittee's principal concerns is to review the impact of its amendments respecting the contract approval process and the imposition of a one-year time limit on CFTC consideration. The imposition of a time limit on contract approvals was in accordance with the suggestions of the exchanges, although we sought a shorter period. We believe the time limit has worked well. Our complaint, which we raised at the time the legislation was adopted, is that the statute affords the Commission's staff excessive power over the terms of new contracts. The staff of the Commission, has delayed or threatened to delay consideration by the expedient of deeming an application deficient, when unprepared to act or when a submission which was otherwise complete and met all requirements of law did not accord with staff's notion of the best possible contract. It has been the experience of the Chicago Mercantile Exchange that competitive pressures or the needs of our constituency are such that we have acceded to the requests of staff for changes despite the fact that it was our firm belief that our

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1/ For example, we urged that the Commission be barred from prosecuting and punishing an individual for the same conduct that had been the subject of an exchange proceeding unless the Commission first found that the individual was not properly punished. The rejection by Congress of that amendment has resulted in certain subsequent prosecutions which have made it more difficult for exchanges to secure witness cooperation and guilty pleas.

contract as submitted was lawful and complete. The power to delay processing for a year's time or longer includes the power to impose terms and conditions that might not otherwise be acceptable to the exchanges.

We do not assert, by the foregoing, that the staff of the CFTC is off on a frolic of its own. Instead, the staff is laboring under the statutory duty imposed by §5(g) of the Act to insure that each exchange has demonstrated that "transactions for future delivery in the commodity for which designation as a contract market is sought, will not be contrary to the public interest." The Commission must act as if this language, which was rigorously objected to by the industry during the course of the 1982 reauthorization proceedings, had some specific and significant content. Thus, the Commission must devote its resources to insuring that the "public interest" is protected during the course of designation proceedings. However, the "public interest" as used in §5(g) has never been properly defined nor, according to economists familiar with the industry, does it have any content beyond the specific requirements of §5 relating to contract market designation, e.g., the ability to prevent manipulation, delivery standards, membership standards, etc. Nonetheless, because the section was enacted and because Congress declined to remove it from the Act, the Commission feels that there must be some duty that it ought to be performing in this area.

This often means that the Commission feels obligated to set itself up as the final judge of the "best" terms of a proposed futures contract. Obviously, the Commission has no experience in designing such contracts, nor does it have the financial incentives or the risk of loss of reputation of the exchange proposing the contract.

It is important for this Subcommittee to understand that the Chicago Mercantile Exchange does not arbitrarily chose terms of contracts. Substantial research and development efforts are the norm. Nor does it frivolously introduce such contracts. Launching a new contract costs many hundreds of thousands of dollars. The failure of a contract means the loss of those funds, the loss of the executive time devoted to the launching of the contract and, to some extent, a loss of prestige in the highly competitive arena by which the various futures markets measure their success against each other. These internalized incentives are a greater assurance of useful new contracts than a vague "public interest test."

This Subcommittee also expressed interest in the implementation of the recent amendments to §5a(12) relating to the submission of rules for approval by the Commission. During the reauthorization proceedings, the industry expressed a great deal of displeasure with the delays encountered during the course of submitting rules for Commission approval and also with the amount of wasteful paperwork generated during the course of such proceedings. The industry proposed that the CFTC be given a very limited time within which to disapprove rules and that any CFTC disapproval specify the section of the statute that the proposed rule violated. The industry also sought to eliminate the publication requirements.

The industry's suggestions were rejected. Instead, a somewhat more convoluted approach was chosen. Congress restricted the approval process to rules which relate to terms and conditions in contracts of sale: however, Congress afforded the Commission the power to define "terms and conditions." The Commission was also afforded the opportunity to subject any other rule amendment or adoption to the full review process by the expedient of informing the exchange within ten days of submission that the rule was to be reviewed. Congress sought to protect the exchanges from excessive discretionary reviews by requiring that "the determination to review such rules for approval shall not be delegable to any employee of the Commission." In our opinion, these changes have not been implemented in accordance with the spirit of the amendments. In particular, the Commission has misused its power to define "terms and conditions," has usurped authority over certain option margins despite clear Congressional expressions to the contrary and has effectively delegated the power to determine which rules are subject to discretionary rule review.

While Congress intended to grant the Commission power to define terms and conditions in contracts of sale, it is equally obvious that the Commission's power is subject to logical bounds based on past usage and the Congressional intent as expressed in the debates and reports. The purpose of the change in §5a(12) was to limit the Commission's oversight to areas where it was appropriate and to avoid the unnecessary and undue interference with everyday exchange operations that was rampant prior to the amendment. It does not appear that the Commission promulgated Regulation §1.41(a)(2) which defines "terms and conditions" in accordance with that Congressional purpose. Instead, the Commission broadly defined the expression in a manner which will create confusion and force oversubmission of rules. In addition, the Commission has embraced all so called "trading requirements" within the concept of terms and conditions of contracts of sale. This reading is not justified by the legislative history, it is contrary to past practice, and broadly expands the definition of rules that need be submitted for prior approval. For example, the establishment of settlement prices, position reporting requirements, and requirements relating to the listing of contracts have nothing whatsoever to do with the terms and conditions of the contract. Those are operational matters.

We would like to formally note and reassert our longstanding objection to the Commission's usurpation of authority over the payment or collection of commodity option premiums and margins. The Commission's assertion of authority is based on its unsupported insertion of the word "futures" before margins in §5a(12) of the Act and on its insistence that the specific prohibition on its authority over the level of margins set by contract markets is abrogated by the general grant of authority to regulate options trading. The Commission's position is inconsistent with every principle of statutory interpretation. Its insistence that it is merely defining contract "terms and conditions" is disingenuous.

We also object to the delegation by the Commission to the Directors of the Division of Trading and Markets and Economics and Education of the authority to determine which rules ought to be subject to full Commission review. The Commission's argument—that the Directors have only been delegated authority to decide which rules do not require Commission review—is an inappropriate departure from the statutory mandate. The act of selecting the rules that do not require review will obviously produce a list of rule submissions that do require review.

We do not intend to distort the Commission's record by our strongly worded emphasis on the foregoing matters. As has been noted, our overall experience with the Commission's rule approval procedures and contract market designation procedures have been good. However, if the Commission were not forced to perform functions for which it is unsuited, that is if it were not required to perform some amorphous public interest test and if it strictly complied with §5a(12) of the Act and limited itself to considering only whether a proposed rule specifically violated some provision of the Act or some existing regulation, then these functions would proceed more smoothly, more efficiently, and at less cost to the government and the public.

We are not able to comment on the Commission's performance of the studies mandated by the 1982 Act at this time. However, it does appear to us that at least one of those studies was so poorly defined at its conception that no effort of the Commission, no matter how intensive, intelligent or well directed, can produce fruitful results. We refer, of course, to the study of insider trading in futures markets. That study was an afterthought given approximately ten minutes consideration before being added to a bill that was the product of many months of negotiation, study, discussion and drafting. The study, as defined by §23(b) of the Act, is both too narrow and includes a presumption that the use of certain types of information abuses customers or the market. A proper study would begin with an economic analysis to determine whether there is a type of conduct which might broadly be designated insider trading which either affects the efficiency of the markets or which might be perceived as so unfair as to interfere with market usage by public customers. If such a general inquiry leads to the conclusion that there may be such behavior, then a specific inquiry into whether that behavior has occurred, whether exchanges are currently in a position to prevent it and whether, if not, further Congressional action is necessary might be undertaken.

We have a special interest in avoiding studies that are not properly defined. First, our industry is being studied to death. In addition to the studies actually authorized by Congress, the Federal Reserve, and the Bush Task Force, the GAO was recently requested by the Honorable Timothy Wirth to conduct a study of the securities industry and has undertaken on its own initiative to expand that study to include the futures industry. We incur substantial costs in cooperating with each of these ongoing studies in terms of executive time and clerical manpower involved in gathering the data and submitting to interviews. Moreover, especially in those cases where we believe the studies are entirely misdirected or undefined, in the sense that they have no sound underpinnings, we have been forced to go to the expense, with other members of the industry, to find independent economists to study the same questions so that a reasoned, rational and unquestionably independent countervoice can be heard. In these times of incredible deficits it does not appear wise to cause the government to bear the expense of studies that have not been thought out in advance and to force the industry to bear the costs of counter studies.

The Subcommittee also asked for any comments we might have on the agricultural option program. We would like to take one step back and comment generally on the option program. Commodity option trading had a terrible reputation in this country at the time of the reauthorization proceedings. This reputation did not stem from any action or inaction by the regulated commodity exchanges or by any persons whose commodity option business was being regulated by such exchanges. Instead the reputation stemmed from abuses in connection with so called London options and also with abuses committed by totally unregulated boiler room operators. Those abuses occurred specifically because the options were not traded on regulated contract markets where a free and open auction market sets the price of the options and where the individuals dealing with public customers have no greater inducements to sell options than to sell any other commodity. Nonetheless, despite the fact that requiring that options transactions be done on exchanges, subject to the full panoply of self regulation, was likely to cure the abuses, Congress and the CFTC both took the most conservative course and treated options as if there might be some inherent defect that made them susceptible to fraud or customer abuse. Given the climate of the times, that approach was probably inevitable. The Commission's initial approach to the licensing of exchanges to trade options was conservative and in fact highly restrictive. Each exchange was limited to two options and special customer protections were required. The initial audits of the option sales practices, and the fact that there has been no public abuse during the first year of trading, tends to confirm the industry's view that the abuses had nothing to do with the fact that the contract traded was an option but had to do with the off-exchange status of options.

We are pleased to report that the Commission has apparently satisfied itself that options can be traded on exchanges without any extraordinary danger of customer abuses and is considering certain petitions to open the option program up at a date earlier than originally contemplated. The demand from institutional users of futures markets for the product is great and the competitive pressure being experienced by reason of SEC approval of option trading on similar instruments is putting the futures industry at a tremendous, artificial, competitive disadvantage in the option arena. We wish to commend the Commission for seriously undertaking to study this matter in an entirely rational and dispassionate fashion.

We are submitting for the record, as an attachment to my testimony, a statistical summary of our experience with the Commission in connection with the submission of new contracts for designation and with the submission of rule amendments. That statistical summary also includes our comments on specific actions of the Commission with which we disagreed. We hope that the Chairman will agree to make that part of the record at this proceeding.

If you do have any questions, I would be pleased to answer them.

APPENDIX I

NEW CONTRACT SUBMISSIONS DURING 1983

During 1983, the Chicago Mercantile Exchange sought designation to trade four new contracts: Deutschemark Options; Standard & Poor's 100 Futures; CME Industrial Average; and Crude Oil. The Chicago Mercantile Exchange agreed to stay processing of the CME Industrial Average contract pending the resolution of the lawsuit between the Chicago Board of Trade and Dow Jones respecting the question of using the Dow Jones Industrial Averages without a license. The Chicago Mercantile Exchange does not intend to go forward with that contract at this time in light of the resolution of this litigation.

The Crude Oil contract was submitted on September 2, 1983, and as yet no action has been taken.

The Standard & Poor's 100 Stock Price Index Futures Contract was submitted on May 2, 1983, and approved on July 12, 1983. This extremely fast action is indicative of the fact that the CFTC recognized that this contract was substantially similar to the previously approved Standard & Poor's 500 futures contract and that it would be wasteful to duplicate the work performed in analyzing and assessing that contract.

The Deutschemark Option contract did not receive such speedy or smooth treatment. That contract was originally submitted on February 18, 1983, and after two deficiency letters, finally approved on December 13, 1983. In order to secure approval by December 13, 1983, the Chicago Mercantile Exchange was forced to acquiesce to changes requested by the CFTC staff which we did not believe were warranted or useful. In the end, however, it was more important to the exchange to secure prompt approval than to secure our vision of a perfect contract.

It would appear that the time limits imposed by the 1982 amendments have had a positive impact. For example, we submitted our contract for Gold Coin Futures on February 20, 1981. Seven requests for additional information were received before the contract was in a position to be approved on December 20, 1983.

APPENDIX II

RULE REVISION AND AMENDMENT SUBMISSIONS

The Chicago Mercantile Exchange submits rule amendments and new rules for review by the CFTC from two separate sources: our Legal Department and our Research Department. Ordinarily, our Research Department is responsible for rule submissions relating to existing or new contracts and our Legal Department is responsible for rules relating to the corporate organization, membership requirements, financial requirements, and trading requirements. During the period 1983 through 1984, our Legal Department submitted 18 rules for which written responses from the CFTC were required. The following summarizes the types of submissions, their number and the average elapsed time of response and is followed by a more detailed explanation of each of the submissions and the CFTC's responses:

CFTC Submissions 1983-1984

Type of Submission	Number of Submissions	Average Elapsed Time of Response (Business Days)
1.41(b)	2	23.5
1.41(c)	13	11
1.41(d)	3[1/]	12

Legal Department Submissions 1983-1984

Date of Submission	Subject	Submission Type	CFTC Response
2/3/83	Amendment to Definition of Deep Out of the Money	1.41(c)	3/1/83 - request to resubmit under 1.41(b) (Time: 18 business days)
2/7/83	Committee Restructure	1.41(c)	3/2/83 - telephone conversation with L. Kurjan. 3/4/83 letter—does not require prior CFTC approval. (Time: 11 business days)
2/24/83	Rule 248—Appointed Industry Governors	1.41(d)	No response required (Time: N/A)

[1/] Only submissions in which a written response was received are included.

4/18/83	Rules 434, 435, and 402-405	1.41(c)	4/22/83 letter—does not require prior CFTC approval (Time: 4 business days)
4/13/83	Rule 1005	1.41(d)	4/18/83 letter - accepted as 1.41(c) submission - does not require prior CFTC approval (Time: 3 business days)
5/11/83	Branch Office Status for Certain APs of FCMs	1.41(c)	No response required. Notification to CFTC of Notice to our Membership Implementing an Already Existing Registration Requirement (Time: N/A)
6/16/83	Customer Substitution in the Event of a Clearing Member Bankruptcy	1.41(b)	8/26/83 - approval letter (See 7/27/83 submission for elapsed time)
6/16/83	Amendment to Rule 413	1.41(b)	8/4/83 - approval letter (Time: 35 business days)
6/24/83	Amendment to Rule 217	1.41(c)	8/12/83 - letter does not require prior CFTC approval (Time: 35 business days)
7/15/83	Amendments to Rules 260, 291 and 407	1.41(d)	8/4/83 - letter Rules 291 & 407 should have been submitted under 1.41(c) - None of amendments require prior CFTC approval (Time: 21 business days)
7/27/83	Customer Substitution in the Event of Clearing Member Bankruptcy	1.41(b)	See 8/16/83 submission
8/16/83	Above substitution made applicable to agricultural as well as financial commodities		8/24/83 approved (Time: 12 business days from amended submission)

8/5/83	Board Representation Restructure	1.41(c)	8/12/83 - letter does not require prior CFTC approval (Time: 5 business days)
8/18/83	Temporary Emergency in August Pork Bellies Contract	1.41(f)	No written approval (Time: N/A)
10/5/83	Rule 816 amendment	1.41(c)	10/24/83 letter - does require prior CFTC approval (Time: 13 business days)
10/12/83	Restructuring Pit Committee	1.41(c)	10/18/83 letter - does require prior CFTC approval (Time: 4 business days)
11/2/83	Member-to-Member Arbitration amendments	1.41(c)	11/7/83 letter - does not require prior CFTC approval (Time: 3 business days)
11/8/83	Rules 106.D.10 106.D.11	1.41(c)	11/25/83 letter - asked to resubmit pursuant to 1.41(b) 11/30/83 - CME resubmitted under 1.41(b) format 12/28/83 - CME changed commencement date of rule amendments. 2/2/84 - CFTC reply requesting additional information (Time elapsed since last CME submission - 26 business days)
11/22/83	Increases in Exchange Fees	1.41(d)	12/9/83 - should have been 1.41(c) submission - approved (Time: 13 business days)

12/15/83	Rule 254, Employee Gift Rule	1.41(d)	No response necessary (Time: N/A)
12/16/83	Qualification for CME membership	1.41(c)	10/31/83 - request for submission 12/23/83 - letter does not require prior CFTC approval (Time: 5 business days)
12/20/83	MRs Allowed to Trade Gold	1.41(c)	12/23/83 letter - does not require prior CFTC approval (Time: 3 business days)
12/28/83	Elimination of Option Expiration Clearing Fees	1.41(d)	No response necessary (Time: N/A)
1/3/84	Regulation of IB's re: CFTC Reg. 33.4(c)	1.41(c)	1/13/84 - letter does not require prior CFTC approval (Time: 8 business days)
1/3/84	Clearing House Fees	1.41(d)	No response necessary (Time: N/A)
1/9/84	106.D. Working Rule (Lessee Positive Net Worth)	1.41(c)	1/20/84 - letter does not require prior CFTC approval (Time: 9 business days)
1/17/84	Delisting of Dutch Guilder	1.41(d)	No response necessary (Time: N/A)
2/9/84	Additional Exchange Committees Created	1.41(d)	No response necessary (Time: N/A)

The Research Department has had equally good experiences with the promptness of processing of new rules. This CFTC properly dealt with all rules that were entirely administrative in nature and such changes were promptly put into effect. Fourteen rule changes of a more substantive nature were submitted to the Commission, of these, 11 were approved with an average approval time of 55 days. The longest delay experienced was 185 days and the quickest action, in two cases, was 19 days. Three proposed rule changes are still outstanding and the longest pending request has been under consideration for 113 days.

The only concern of the Research Department is that the CFTC continues to insist that certain modifications or changes in the item delivered constitute rule changes of the Chicago Mercantile Exchange. The CFTC insists that all such changes be submitted to it in advance of implementation despite the fact that advance submission is, in most cases, impossible. For example, the Chicago Mercantile Exchange Standard & Poor's 500 futures contract specifies cash delivery based on the index as composed by an independent third party on the settlement date. The content of the Standard & Poor's 500 index changes regularly as companies merged, go out of business, or become more prominent in their businesses. All person who use the Standard & Poor's 500 index for business purposes understand that these changes are necessary and that they are the result of decisions made by an independent party. In fact, all Exchange literature respecting the contract makes this clear as well as the terms of the contract. Nonetheless, the Commission insists that each change resulting in the addition or subtraction of a company from the Standard & Poor's 500 index constitutes a rule change of the Chicago Mercantile Exchange. This is an unjustified and unworkable position.

The same is true of certain hard commodities traded on the Exchange. For example, our Crude Oil contract specifies that all oil delivered must meet the specifications of the pipeline through which such deliveries are made as at the date of delivery. This term is an obvious and necessary part of the contract. The Chicago Mercantile Exchange does not control changes in the specifications of the pipeline. Therefore, such changes cannot be thought to be changes in the rules of the Exchange. In fact, the Exchange rule is general and embraces such changes in advance. Nonetheless, the Commission insists on defining such changes in specifications as changes in the terms and conditions of Chicago Mercantile Exchange contracts. This can create obvious problems if such a change occurs near a delivery date and if the CFTC has not acted or has not had an opportunity to act.

The claim by the CFTC that we can deal with this by an emergency action is accurate, but uninformative. There is no reason why an Exchange has to take an emergency action when the emergency consists of nothing more than the CFTC's misdefinition of an ordinary commercial event.

TESTIMONY OF

ROBERT ISAACSON, DIRECTOR
NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Good Afternoon.

My name is Robert Isaacson. I am a director of the National Association of Futures Trading Advisors (NAFTA), a national trade association consisting of commodity money management professionals. NAFTA has 175 members, who manage approximately $800 million in commodity investments for over 5,000 clients. Our members are active as commodity trading advisors and commodity pool operators; they operate or advise a substantial number of the pools and managed accounts currently in existence.

NAFTA welcomes this opportunity to report to the Committee on the experience of its members in operating under the current regulatory structure governing the futures industry. We are pleased to report that the National Futures Association (NFA) has fulfilled the expectations of the futures industry regarding self-regulation. The development of NFA and its assumption of growing responsibilities over the past eighteen months have to a great extent made regulation more efficient and more protective of the public interest.

Among the accomplishments of NFA that NAFTA deems particularly noteworthy are its registration of introducing brokers and their associated persons, its establishment of new and workable arbitration procedures, and its development of a thoroughgoing audit program for NFA members, including advisors and pool operators.

Registration

NFA has implemented its program for registration of introducing brokers and their associated persons in an efficient and satisfactory manner. Registration staff are accessible and knowledgeable. NAFTA has full confidence that NFA will serve the public and the industry well when its registration responsibilities are expanded in the near future to include registration of pool operators and trading advisors.

As NFA expands its registration duties, testing requirements will be established. NAFTA welcomes this development as a means of enhancing professionalism within our industry. We are working with NFA staff to develop tests for the associated persons of pool operators and trading advisors. These tests will be "custom-made" for these categories of applicants for registration. As a result, applicants will be required to demonstrate a working knowledge of the legal and compliance requirements pertaining to their activities.

Arbitration

The development of the NFA arbitration program is another promising aspect of NFA's growth. The NFA arbitration system has been in operation for almost a year. Over 100 notices of intent to arbitrate have been received, and over 50 demands for arbitration made. NAFTA believes that as the availability of this forum for dispute resolution becomes more widely known, it will provide a popular alternative to litigation and arbitration in other forums. The average time for resolution of a dispute through NFA arbitration is significantly shorter than that for litigation. In addition, the costs of NFA arbitration are generally far less than those entailed in litigation.

Another indication of the favorable industry response to the availability of NFA arbitration is the number of industry members who have volunteered to act as arbitrators on NFA panels. To date, over 200 individuals in 30 states have been selected as NFA arbitrators. They constitute a unique pool of futures industry expertise.

Audits

A third area of NFA accomplishment involves its comprehensive audit program. NAFTA is particularly interested in the NFA audit program because it constitutes the primary mechanism for overseeing compliance of pool operators and trading advisors with CFTC and NFA rules. Although this audit function could be performed with only a narrow focus on enforcement, NFA audits have concentrated on member education as well.

Many NAFTA members are relatively small pool operators or trading advisors. These members have been assisted by NFA staff in implementing changes in record keeping and reporting procedures, and in modifying their disclosure documents to conform to applicable CFTC and NFA requirements. NAFTA believes that an essential element of industry self-regulation is education of members as to their regulatory and compliance responsibilities because a large percentage of technical violations arise from incomplete understanding of applicable rules. NAFTA specifically wishes to acknowledge the assistance received by NAFTA members from NFA staff in developing and improving their compliance procedures.

NAFTA also believes that industry self-regulation requires a concerted effort by industry members to identify those among them who fail to comply with the standards established for the conduct of all members, and to institute appropriate corrective actions. NAFTA members have from time to time informed NFA of examples of misbehavior by industry members. NFA staff have acted promptly on these suggestions and have initiated audits or investigations of members whose business practices have been questioned.

The particular examples of NFA performance cited in our testimony should underscore a development viewed by NAFTA and its members as having even more important long-run consequences: the development of an effective working relationship between NFA and the industry that it regulates. This relationship between NFA and the industry is characterized by a high degree of mutual respect, a willingness to understand conflicting viewpoints, and a desire to accommodate them where possible. NFA accomplishments since its inception have been made possible by a working environment conducive to effective self-regulation.

Thank you for your attention. At the conclusion of Ted Thomte's testimony, both he and I would be pleased to respond to any questions or comments you may have.

TESTIMONY OF

THEODORE THOMTE, DIRECTOR
NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

My name is Theodore Thomte. I am a director of the National Association of Futures Trading Advisors (NAFTA) and serve as chairman of NAFTA's Government Relations Committee. I would like to endorse the comments of my colleague, Mr. Isaacson, concerning NAFTA's general satisfaction with the efforts of the CFTC and the NFA in regulating the futures industry, particularly the highly specialized segment of the industry comprised of advisors and pool operators. To an unusual degree, these agencies as well as state regulatory authorities have succeeded in coordinating their regulatory programs, to the benefit of both the public and the industry.

An important example of regulatory cooperation is that of the CFTC, NFA and state securities agencies developing an enforcement program directed at off-exchange commodities fraud. The CFTC, NFA and the North American Securities Administrators Association (NASAA) have strengthened investor protection by their joint enforcement activities, as mandated by the Futures Trading Act of 1982.

NAFTA is compelled, however, to draw to the Committee's attention one area where the mandate of the 1982 Act has been systematically ignored. The states, through NASAA, have persisted in their attempts to regulate the substance and structure of commodity pools, despite contrary intentions expressed repeatedly by Congress. On January 1, 1984, new Guidelines for Registration of Commodity Pool Programs were promulgated by NASAA. These Guidelines specify in detail the permissible structure of publicly offered commodity pools. As such, the Guidelines are contrary to the philosophy of full disclosure incorporated in both CFTC and federal securities regulation applicable to commodity pools. As a result, the development of new types of pool structures has been inhibited, and marketplace competition among products has been replaced by arbitrary and ill-informed judgments by regulatory authorities whose knowledge of the futures industry is limited because they do not regularly oversee commodity pools.

These state Guidelines are contrary to the intent of Congress - a fact that is clear from the legislative history of every major piece of futures legislation adopted in the past ten years. Because of the expense involved in challenging these Guidelines in court, industry members necessarily have not attempted to block their application.

This issue was discussed extensively during the 1982 CFTC reauthorization hearings. At that time, this Committee expressed its view as follows:

> Chairman Helms offered another amendment relating to commodity pools. The amendment would add a provision to new subsection (2) to be added by the bill to section 4m of the Act. The amendment would provide that 'the provisions of this Act shall preclude the qualification or substantive regulation of commodity pools under the various laws of the several States dealing with the qualification or regulation of securities or otherwise in those States.' Chairman Helms explained that the amendment would clar-

ify existing law by explicitly stating that the Commodity Exchange Act preempts all substantive State regulation of commodity pools under the various laws of those States. If a commodity pool is regulated by both the CFTC and the SEC, additional regulation by the States is neither needed nor desirable. He also stated that the Commission believes that existing law is clear and the amendment is not needed.

After discussion, the Committee decided not to adopt the amendment since the law is clear and the amendment is, therefore, not needed. However, the Committee reiterates that Federal jurisdiction under the Commodity Exchange Act is exclusive vis-a-vis the several States, and that the several States are specifically preempted from the substantive regulation or qualification of commodity pools and commodity pool operators. In 1974 and again in 1978, the Congress expressed its intent that the Commission have exclusive jurisdiction over the substantive aspects of futures trading and and that unnecessary and duplicative regulation of the commodities industry be avoided. Notwithstanding this clear expression of congressional intent, however, many State securities administrators insisted or attempted to insist on State qualification of commodity pools under the blue sky laws of their various jurisdictions. In addition, many State regulators have imposed or attempted to impose substantive regulation on commodity pools and commodity pool operators that conflicts with Commission regulatory policy or imposes imposes requirements which the Commission has specifically considered and rejected. Lastly, many State securities administrators now contemplate regulating the timing and method of compensation paid to the commodity pool operator.

The practical effect of this State regulation is to increase the cost to the investing public without any appreciable corresponding benefit. Since all commodity pools are subject to Commission regulation and since certain activities of commodity pools are also subject to both Commission and Securities and Ex-

> change Commission regulation, State regulation of the same activity is clearly duplicative. The Committee notes that it was given the opportunity to restrict the exclusive jurisdiction provision of the Act with respect to State jurisdiction over commodity pools, commodity pool operators, and others during the course of the preparation of the bill and specifically chose not to do so. In light of the foregoing, it should be clear that the several States are specifically preempted from the substantive regulation or qualification of commodity pools and commodity pool operators.*

The Conference Committee Report accompanying the Futures Trading Act of 1982 clearly incorporated these views:

> The conferees intend that nothing contained in this provision will permit any state to impose, or to initiate any suit, action or proceeding for an alleged violation of any State licensing, registration, or qualification requirement provided for under any State securities or commodities statute. Similarly, nothing in this provision permits any State to initiate any suit, action or proceeding against a person registered under the Act for an alleged violation of any rule, regulation, guideline or statement of general policy issued under any State securities or commodities statute.**

NAFTA is concerned about the impact of NASAA's continued disregard of the intentions of Congress. We urge the Committee to take steps to assert more forcefully the will of Congress that the states have no role in the substantive regulation of commodity pools. We wish to emphasize that we strongly support state enforcement authority, authorized under the Commodity Exchange Act, and we believe the states have an important role to play in enforcing provisions of the Act.

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* Report No. 97-384 to accompany S. 2109, 97th Cong., 2d Sess., as reported in CCH Comm. Fut. L. Rep. No. 174, CCH Special 2, at 81, (May 18, 1982).

**Conference Report No. 964, 97th Cong., 2d Sess., as reported in CCH Comm. Fut. L. Rep. No. 190, Special Report, Part II, at 43 (December 27, 1982).

With the exception of the state pool guidelines, NAFTA believes that the agencies responsible for regulation of the futures industry have diligently discharged their responsibilities and have created a regulatory framework of the public. NAFTA is especially appreciative of the CFTC's action in designating a special counsel for regulatory matters affecting pool operators and trading advisors - an action which we believe is generally symbolic of the CFTC's recognition of the highly specialized nature of our area of the futures industry.

We appreciate the opportunity to appear before this Committee and we would be happy to elaborate our views to members of the Committee or its staff.

STATEMENT OF PHILIP A. FEIGIN, ASSISTANT SECURITIES COMMISSIONER, COLORADO DIVISION OF SECURITIES AND CHAIRMAN, SPECIAL PROJECTS COMMITTEE, ENFORCEMENT SECTION, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

I am pleased to have the opportunity to appear before you today as a representative of the North American Securities Administrators Association, Inc. ("NASAA"). By way of introduction, I am the Assistant Securities Commissioner for the Colorado Division of Securities and have been involved in state securities regulation, first in Wisconsin and then in Colorado, for almost five years. I am currently the chairman of the NASAA Special Projects Committee, serve on the Commodities Committee and as enforcement liaison to the CFTC and the NFA. I have appeared as a panelist at CFTC and NASAA seminars dealing with commodities-related fraud and prosecution. While it must be understood that my comments today cannot be taken as those of every NASAA member jurisdiction, I believe my participation on the various commodities-related committees of the organization provide me with broadly-based perspectives, which are representative of NASAA as a whole.

Fundamental Developments

In the last year or so, we have witnessed some fundamental and extremely important developments in commodities regulation generally and in the war against so-called "off-exchange" commodities-related fraud in particular.

1. Section 12(e) of the Commodity Exchange Act - "The Open Season Provision"

The most important single development in the last several years from the states' viewpoint was the enactment of section 12(e), the so-called "open season provision," as an addition to the Commodity Exchange Act. This provision authorizes the states to enforce any applicable law under which they have jurisdiction against off-exchange commodities-related products and those selling them, if such sales are illegal under the Commodity Exchange Act. More specifically, state securities agencies are no longer preempted from asserting jurisdiction under their securities laws over unregulated, off-exchange commodities investments and sellers. This is not a role with which we are unfamiliar.

Over the last seventy years of state securities regulation, the states have traditionally led the fight against fraud involving what have come to be known as "exotic investments." Our grassroots presence in every state and the flexibility of remedies available to us have afforded the opportunity to learn of these schemes quickly and to respond effectively. It is generally believed that section 12(e) returns to the states the opportunity to pursue what amounts to nothing more than another "exotic," the commodities scam.

2. Section 6d of the Commodity Exchange Act

Section 6d was added to the Commodity Exchange Act in 1978. It empowers the states to enforce the Act in federal court. For a variety of reasons, section 6d has not been employed by the states to any great degree, a contributing factor in the development of section 12(e).

In 1983, a new provision was added to section 6d authorizing the states to proceed in state court to enforce the anti-fraud provisions of the Commodity Exchange Act against most CFTC registrants. Prior notice to the CFTC is required, and either the CFTC or the defendant may remove the matter to federal court. This removal provision may deter the states' utilization of the remedy as they have shown a reluctance to bring cases in federal court in the past under the 1978 version of section 6d.

However, the 1983 amendment to section 6c may breathe new life into section 6d. Section 6c provides that an ex parte restraining order to enjoin violations of the Commodity Exchange Act is available and may include prohibitions against destruction of records and dissipation of assets. Records and assets can be frozen and access is ordered. This is extraordinary relief not generally available under state securities laws. Add to that the nationwide application of such an order and the fact that such an order may be obtainable in a state court (albeit subject to removal) and there may well be sufficient inducement for state securities agencies to venture into the unfamiliar arena of federal court.

3. Section 8e of the Commodity Exchange Act

One of the most frustrating aspects of dealing with the CFTC in the past was the statutory prohibition forbidding the Commission to share information with state securities regulators. This was another factor in the failure of section 6d as a useful remedy. The 1983 amendment to section 8e provides the states broad and substantive access to CFTC information, thus removing a serious impediment to cooperation in enforcement.

4. CFTC Interim Final Rules for Certain Leverage Transactions

For many years now, so-called "leverage" dealers have prospered in a regulatory atmosphere of vagueness, preemption and inaction, and in large part, at the expense of an unsuspecting public. In early 1984, the CFTC attempted to clarify its jurisdiction in the leverage area with the adoption of long awaited rules.

These rules define leverage contracts for purposes of section 19 of the Commodity Exchange Act, impose substantive regulation on those who would sell them, and provide heretofore unavailable protections for those who purchase them. Unfortunately, as I will later discuss, the rules leave many important issues unresolved, creating almost as many questions as they answer.

E. The National Futures Association

While still in its infancy, the NFA has embarked on a course providing a high degree of cooperation with state securities agencies, including the dedication and commitment to stamping out off-exchange commodities-related fraud. This is a most commendable attitude considering the fact that the NFA's charge could easily be interpreted as limiting the organization's activities to the more sophisticated confines of the exchanges. The NFA has offered its expertise to the states in the form of training, surveillance, investigation and expert testimony, and I feel confident that this new and promising resource will be put to good use by the states.

These fundamental developments have contributed to the creation of a new scheme of regulation based on a new combination of federal, state and self-regulatory responsibilities. As with any new system, there are benefits and problems, both anticipated and unexpected.

Where Are We Now?

The developments described are very positive steps, but must be viewed in the context of disastrous failures of regulation in the past. They arrive in the wake of the collapse of both International Gold Bullion Exchange ("IGBE") and Bullion Reserve of North America ("BRNA"), and in the midst of the proliferation of boiler rooms across the country selling fraudulent metals investments with virtual impugnity. Thousands have been victimized. Thousands more will be victimized in the absence of an intense enforcement crackdown at all levels.

1. The CFTC and Off-Exchange Instruments

I believe it is fair to say that in adopting the leverage rules and in light of section 12(e), the CFTC attempted to limit its jurisdiction and its responsibilities in the off-exchange area. Pursuant to section 31.4(w) of the rules, only contracts ten years or longer involving the purchase of designated commodities ("long" contracts) meeting other technical requirements are leverage contracts. But what about a purchase contract of nine years, 364 days? Or a twenty year contract meeting all other leverage specifications but for the purchase of titanium? Or a twenty year contract for the sale of gold ("short" contracts)? Are these not leverage contracts within the meaning of section 19 of the Commodity Exchange Act? Even if they are not, are they not off-exchange traded futures contracts? On reflection, it would appear that the CFTC has not succeeded in limiting its jurisdiction in the area but has merely underscored and reemphasized questions as to which provisions of the Commodity Exchange Act apply to these ambiguous and illusory instruments, invented for the sole purpose of benefiting those who sell them.

Leaving these esoteric legal issues aside, the CFTC has taken an important step in clarifying its position on leverage in its joint action brought under section 6d with the State of Arizona against Smythe-Wheatley, Ltd. This action involves a section 31.4(w) leverage contract sold by a firm in violation of the leverage moratorium. The clear message from this action is that it is possible to sell an illegal "leverage contract" as defined in the rules. Therefore, firms (other than the four so-called "grandfathered" firms) which sell instruments falling within the section 31.4(w) definition of "leverage contract" must be viewed as in violation of section 19 of the Commodity Exchange Act. This creates some fascinating questions of state jurisdiction.

2. The States and Off-Exchange Instruments

In considering state jurisdiction in this field, one must understand that state securities case law dealing with commodities-related (particularly off-exchange) instruments was only beginning to develop when the Commodity Exchange Act was adopted. Now, with the addition of section 12(e), it is anticipated that development will continue. However, it is unclear at this point whether state courts will uniformly consider these myriad commodities-related off-exchange traded instruments to be securities. As a result, one must remember that section 12(e) is not an end, only a beginning. Although pursuant to section 12(e), the states are not barred from asserting their blue sky laws, there is nothing in section 12(e) which provides that the blue sky laws are applicable.

Therefore, the first problem faced by the states under the open season provision is proving that leverage contracts are securities. Several circa 1974 cases would support such a contention. These holdings make no distinction based on duration of the contracts or on the commodity involved. Therefore, a "long" contract involving the typical leverage accoutrements (margin, etc.) should be held to be a security under state law. The states should be able to assert their securities law jurisdiction over such contracts and those who sell them, under section 12(e).

It would appear that regulation of some illegally sold leverage contracts may remain under exclusive CFTC jurisdiction. Section 12(e)(2)(C) provides that states may not assert their securities laws against instruments "... subject to regulation by the Commission under section ... 19 of this Act ..." It well may be that the leverage contracts defined in section 31.4(w) of the rules are to be regulated solely by the CFTC, subject exclusively to Commodity Exchange Act enforcement under this "subject to" language of section 12(e). However, under section 12(e)(3), those who sell these 31.4(w) leverage contracts may be subject to state jurisdiction nonetheless, as there is no exclusion in 12(e)(3) similar to the "subject to" exclusion of 12(e)(2). In the case of a non-grandfathered firm, the states may not be able to enforce their blue sky laws against the sale of an unregistered 31.4(w) leverage contract security [section 12(e)(2)(C)], but may be able to pursue the seller of the contract for being an unlicensed broker/dealer or agent [section 12(e)(3)]; a strange result. Contracts outside the 31.4(w) definition will be fair game to the states as well as those who sell them.

Of course, as before, the section 6d remedies will be available to the states in dealing with the illegal sale of an instrument within the exclusive jurisdiction of the CFTC. As previously stated, the extraordinary remedies provided by section 6c may make such actions more attractive to the states in the future. In such actions, the courts may be confronted with the task of determining whether non-31.4(w) leverage contracts are "leverage contracts" under section 19, or off-exchange futures contracts, or both.

In summary, the leverage area is still very confused. The states must establish that these investments constitute securities in order to pursue section 12(e) to its fullest extent. Both the states and the CFTC must pursue with vigor those 31.4(w) leverage contracts sold illegally.

Where Do We Go From Here?

Decades of financial regulation have taught us some hard lessons: as soon as a law is passed, someone is going to devise a way around it; and, it is a lot easier to pull off a scam than it is to stop one. The commodities-related investment frauds of the last decade have taken advantage of regulatory and jurisdictional ambiguities to victimize thousands. We are now entering a period where the states will have a much more active role in battling commodities fraud. The states have taken up the challenge in a three-pronged initiative.

The first phase of the initiative involves education. The states have been relegated to an observer's role for almost a decade. This has led to a general unfamiliarity with the subject area. We must now expand our understanding of how these frauds work and how they may be attacked. In the last two years, through seminars and other programs, state enforcement personnel have received extensive training in the commodities fraud area. NASAA sponsored a seminar in September, 1982 on the Investigation and Prosecution of the Boiler Room. The CFTC has conducted three Cooperative Enforcement Seminars and NASAA has provided funding so that many state enforcement people could attend. Additional programs and panels have been presented on the subject at NASAA's national meetings.

The second phase of the initiative involves actual enforcement actions. While NASAA has no enforcement authority of its own, it provides a very valuable base for the organization and funding of multi-state cooperative enforcement projects. In the last year, NASAA has provided significant funding to the States of New York and Arizona so that out-of-state discovery in commodities cases could be effected. The New York funding led in part to the indictment and arrest of the IGbE principals. The Arizona funding led to the filing of an injunctive action against a strategic metals dealer alleged to be engaged in fraudulent boiler room activity. In addition, Arizona brought a section 6d action in conjunction with the CFTC only a few weeks ago against one of the more notorious non-grandfathered leverage firms operating out of Southern California and Arizona.

In December of 1983, the NASAA Special Projects Committee met in Denver to consider project ideas for 1984. It was the unanimous decision of the committee that the so-called leverage firms proliferating in Southern California posed a most serious threat to investors nationally and in light of the adoption of section 12(e), an important challenge to state securities regulators. The California Department of Corporations has embarked on a program to examine several of the firms to determine if California securities law has been violated. Several other states with potential victims have pledged assistance in the effort. NASAA will provide funding and personnel should California require assistance in legal research, auditing and accounting, out-of-state investigation and expert witness testimony.

As of the end of the week of March 5th, 1984, about twenty metals firms had been subpoenaed. At least six of the subpoenaed firms have simply closed up shop and disappeared. Some of the other firms have complied with the requests while others have said they would not comply. In those cases, subpoena enforcement actions are anticipated.

The goals of the project are to stop what we believe to be fraudulent conduct and to attempt to develop a base of case law on the issue of whether these varied aberrations of traditional commodities instruments constitute securities under state blue sky laws. If they are securities, existing enforcement remedies will be sought on a broad scale in the future. If they are not, the need for statutory change is mandated.

An additional goal of the project is to enhance NASAA's ability to mount multi-state enforcement efforts. Federal fiscal and regulatory policies for the future make it clear that much greater reliance on state enforcement efforts will be the rule not the exception. This poses a special challenge to the states as our investigative tools are generally limited to our own borders. Cooperative methodologies must be developed to effectively deal with WATS line frauds and NASAA is a valuable and essential player in this evolution.

The third phase of the initiative is legislative. Representatives of the CFTC, the NFA and NASAA met in Chicago in mid-January, 1984 to discuss the anticipated adoption of the leverage rules by the CFTC and the ramifications of such adoption for the states. What emerged from this most important discussion was a decision to form a committee of the three organizations to draft a model state act.

This committee met for the first time in February, 1984 in Los Angeles. The most crucial determination was one of approach. After much discussion, it became clear that two potential directions could be taken: one, a law directed at boiler rooms in general; the other, a law directed at the sale of so-called "physical" commodities where delivery is never intended. It was the consensus of the committee that the latter, more narrow, approach be utilized in the preparation of the first draft. This draft will be presented for discussion purposes at the next committee meeting scheduled for Atlanta at the end of March, 1984. The act is designed to confer clear state jurisdiction over the types of frauds perpetrated on the public in the coal cases, New York's Mineral Resources case, by many of the California, Florida and New York metals companies, and -- last but certainly not least -- by IGBE and BRNA.

It is hoped that the model state act will close a gaping hole in the regulatory fabric, created by a variety of factors: state law preemption, the "deferred delivery" exclusion in the Commodity Exchange Act, and the small size and centralized organization of the CFTC. Adoption of the act would clearly have a substantial fiscal impact on state government, a fact of no small concern to NASAA. It is equally as clear that the millions of dollars lost to these frauds in the last few years justifies this new regulatory cost.

Off-Exchange Fraud Summary

We are entering a new era in the battle against off-exchange commodities-related frauds. Many statutory impediments to state participation in this effort have been lifted and initiatives to enhance state capabilities have been undertaken. Significant results have already been obtained. However, we should not become overly optimistic as a result of these initial successes. Substantial problems in regulation remain.

As discussed, there are still numerous areas of ambiguity in the Commodity Exchange Act which will continue to provide fertile ground for the fraud-feasors to ply their trade. Secondly, the very essence of these frauds is a national market, accessed by WATS lines and mass mailings. The abilities of state agencies to combat national frauds are extremely limited. The CFTC is hard pressed to provide an effective enforcement presence at current staffing levels. As examples, at a time the "leverage" firms were proliferating in Southern California, there was but one CFTC attorney stationed in Los Angeles with responsibility for the entire western region of the country. Although Fort Lauderdale has long been referred to in enforcement circles as the "Maggot Mile" (in reference to the multitude of boiler room frauds which have been headquartered in the city), the nearest CFTC office is located 900 miles north in Washington, D.C. The next few years will be crucial in the development of new case law to deal with these career con-men. At present, no one can state with any certainty whether they are regulated by state law. We should have some indication in the next few months.

A Note of Commodity Pools

It is the generally held position of state securities regulators that the state regulation of commodity pools in the capital formation process is not preempted by the Commodity Exchange Act. Nothing occurred in the 1982 reauthorization process to alter this view. In fact, it has been reported to me that commodity pools continue to seek securities registration and exemption in states across the country. It should also be noted that guidelines describing "merit" standards for commodity pool registration were adopted at NASAA's annual meeting in October, 1983.

The courts of at least two states have ruled in support of this view. In Black v. Corporation Division, 54 Or. App. 422, 634 P.2d 1983 (1981), the Oregon Appellate Court upheld the state securities agency's cease and desist order prohibiting the offer or sale of unregistered securities in what was held to be a commodity pool promoted by Black. In Schlatter v. Mo-Comm Futures, Inc., 233 Kan. 324, 622 P.2d 553 (1983), the Kansas Supreme Court held that the Commodity Exchange Act did not preempt the application of the Kansas Securities Act in a private civil action for damages brought for the sale of unregistered securities, to wit: limited partnership interests in a commodity pool. The lower court judgment in favor of plaintiff Schlatter was reversed on other grounds.

In considering both cases, it is important to take note of two points. First, neither pool was registered with the CFTC, and neither was likely exempt (although the possibility exists). Second, both cases arose prior to the 1982 reauthorization proceedings. Nonetheless, the two courts rather clearly expressed the position that in the capital formation stage, commodity pools and those who promote them are subject to state securities registration and fraud provisions.

One final and extremely important comment must be made. Although we have had our differences in the past and will continue to have them, I believe I can speak for NASAA in saying that cooperation between the CFTC and the states has never been better. In addition, it appears that the NFA has adopted a similar cooperative posture. This can only lead to improved regulation and to the benefit of the public we are all charged with protecting.

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